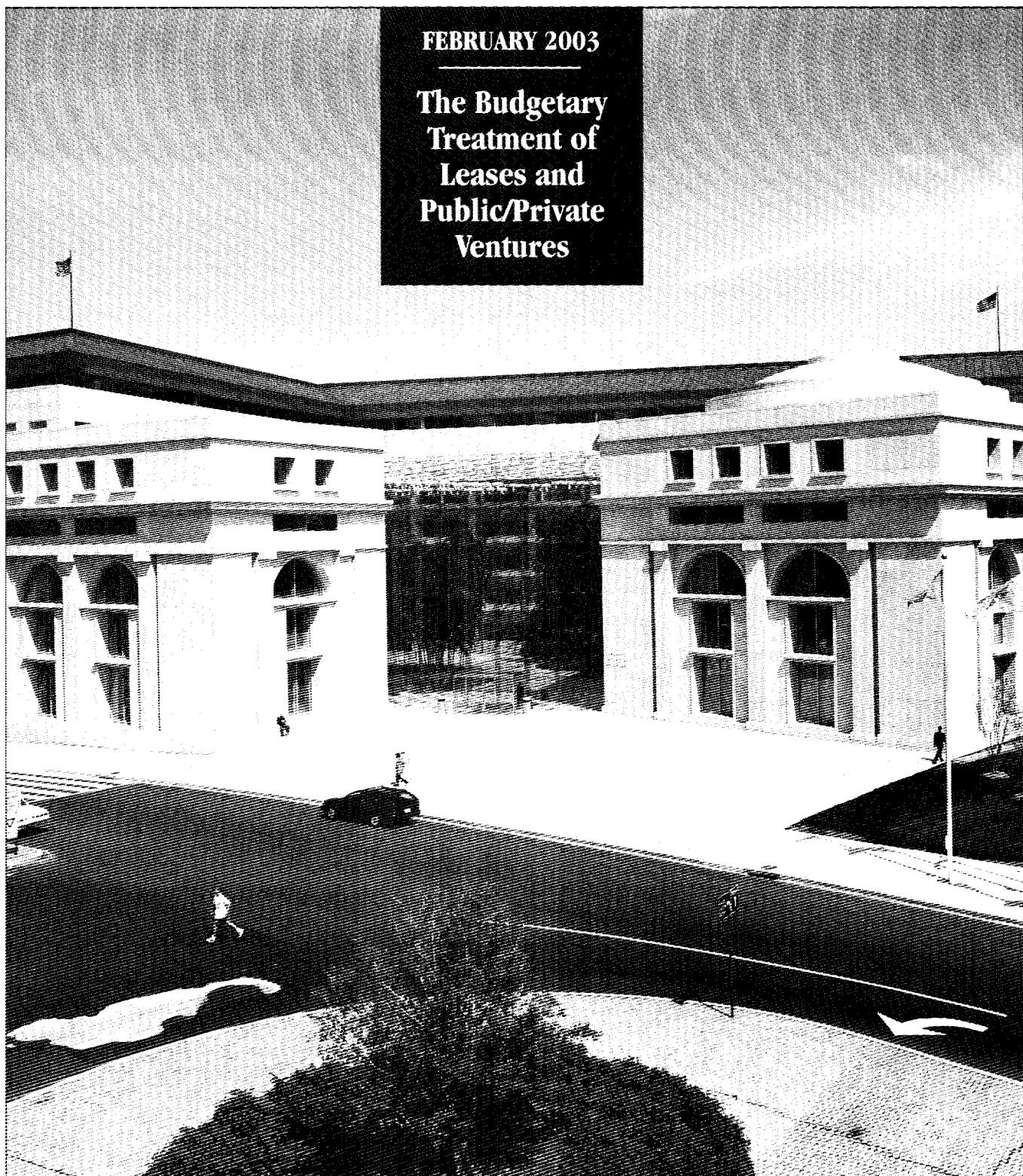


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**The Budgetary
Treatment of
Leases and
Public/Private
Ventures**



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The Budgetary Treatment of Leases and Public/Private Ventures

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The Congress of the United States
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Note

The cover photo shows the Thurgood Marshall Federal Judiciary Building in Washington, D.C. Completed in October 1992, the facility is being acquired by the federal government over a 30-year period using a lease-purchase. (Photo is courtesy of the Architect of the Capitol.)

Preface

Federal agencies sometimes use leases or special-purpose public/private ventures to acquire capital assets without recording their full costs as obligations and outlays up front in the budget. That budgetary practice increased in the 1990s with the Department of Defense's military housing privatization ventures and the Department of Veterans Affairs' enhanced-use leasing ventures. This paper examines agencies' recent use of leases and special-purpose public/private ventures to finance the acquisition of federal assets. It reviews how the Congressional Budget Office (CBO) scores budget authority and outlays for the legislation that provides agencies with the authority to enter into those arrangements and how the Office of Management and Budget records the obligations and outlays associated with specific leases and public/private ventures.

This paper was prepared as part of CBO's continuing analysis of federal budget concepts. Recent papers include *Evaluating and Accounting for Federal Investment in Corporate Stocks and Other Private Securities* (January 2003), *The President's Proposal to Accrue Retirement Costs for Federal Employees* (June 2002), and *Accrual Budgeting for Military Retirees' Health Care* (March 2002). CBO's *Budget and Economic Outlook: Fiscal Years 2004-2013* (January 2003) also includes a discussion titled "Is It Time for a New Budget Concepts Commission?" In keeping with CBO's mandate to provide objective analysis, this report makes no recommendations.

Deborah Clay-Mendez of CBO's National Security Division prepared this paper with significant contributions from Kathleen Gramp of CBO's Budget Analysis Division and Jennifer Smith of CBO's Office of the General Counsel. J. Michael Gilmore, Robert Sunshine, and Robert Murphy supervised the project. Ian MacLeod provided research assistance. The authors gratefully acknowledge the useful comments of many others within CBO, including Kim Cawley, Kent Christensen, Richard Farmer, Peter Fontaine, Deborah Lucas, Marvin Phaup, and Jo Ann Vines. The work also benefited from reviews provided by Richard Kogan and other budget analysts outside of CBO.

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Barry B. Anderson
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Summary

Federal agencies sometimes use long-term leases and special-purpose public/private ventures to acquire capital assets without having to obtain Congressional appropriations for the full costs up front. Depending on their budgetary treatment, such leases and public/private ventures can allow an agency to pay for an asset over time. In the case of a lease, the asset is paid for incrementally, through annual lease payments. In the case of a public/private venture, the asset is paid for over time through the prices the agency pays for the goods and services that it agrees to purchase from the venture or through a lower return on the equity or other valuable considerations that the agency contributes to the venture. In both cases, the financing technique obscures the full costs of the asset. In contrast, if the agency purchased the asset directly, the full costs would appear up front in its budget.

This paper examines recent trends in federal agencies' use of leases and public/private ventures and includes recent examples. It also describes how the Congressional Budget Office (CBO) scores budget authority and outlays for legislation providing authority for leases or public/private ventures and how the Office of Management and Budget (OMB) records the obligations and outlays associated with leases and public/private ventures.¹

This analysis finds that in many instances, long-term leases and public/private ventures used by federal agencies to finance the acquisition of capital assets are treated in the budget in a manner that is inconsistent with two fundamental principles of federal budgeting:

1. Although the term "scoring" is often reserved for the process of identifying and tracking the budget authority and outlays associated with legislative initiatives (legislative scoring), it is sometimes used more broadly to include the activities of OMB as it records the obligations and outlays associated with the actions of federal agencies as they execute the budget.

- First, that federal financial commitments should be recognized up front in the budget, at the time those commitments are made; and
- Second, that the budget should be comprehensive, capturing all financial activities of the federal government.²

A budgetary treatment inconsistent with those principles could deny the Congress and the Administration the information needed to oversee federal spending. Moreover, unless the costs of asset purchases financed through leases and public/private ventures appear up front in the federal budget, in the same way as the costs of assets purchased directly by the government, federal managers will be more likely to rely on such financing techniques even though they are inherently more costly.

Efforts to increase the transparency of the budget in regard to capital acquisitions could take many forms. One approach would be to develop new budgetary guidelines or modify existing ones. Another would be to reinterpret the current guidelines and apply them in a more consistent, inclusive manner. In addition, improvements in the processes that agencies use to plan, budget for, and manage their capital acquisitions could help reduce the incentive that managers now have to try to obtain assets without recognizing the costs up front.

The Budgetary Treatment of Leases

The current guidelines for the budgetary treatment of leases, which were first implemented in 1991, were developed jointly by the House and Senate Budget Committees, OMB, and CBO. Under those guidelines, a long-term lease that—in effect—provides the government with ownership of an asset is scored up front with budget authority equal to the present value of all future lease payments. Such leases include both capital leases (leases in which the government consumes almost all of the services produced by an asset over its useful life) and lease-purchases (leases in which the government purchases the asset at the end of the lease term). That up-front scoring puts such leases on a more equal budgetary footing, that is, on a level playing field, with direct purchases of assets. In contrast, the budget authority for operating leases (leases that are not tantamount to purchases, but which provide the government with access to the services of a commercial asset only for a limited portion of its useful life) can be recorded annually over the life of the lease as lease payments are made.

2. See the President's Commission on Budget Concepts, *Report of the President's Commission on Budget Concepts* (October 1967).

The Origins and Intent of Current Lease Guidelines

Prior to 1991, budgetary guidelines allowed many long-term leases that were the equivalent of purchases to be scored in the budget on an annual basis, as the lease payments were made. In the 1980s, that practice, together with budgetary pressures and tax laws that favored leasing, encouraged many agencies to increase their use of such leases. During that decade, the Department of Defense (DoD) relied on lease-purchases to acquire assets ranging from support ships to on-base housing. By 1990, the Department of Energy had proposed—albeit unsuccessfully—leasing oil for the Strategic Petroleum Reserve.

In 1991, the introduction of the new budgetary guidelines for leases reflected a number of concerns about the growing use of long-term leases to finance asset purchases. Such leases could:

- Reduce the budget's ability to fully depict the federal government's financial commitments;
- Undermine fiscal policy by circumventing controls such as limits on deficits and caps on discretionary spending;
- Allow an agency to avoid facing the full costs of purchasing an asset at the time it decides to buy it, thus making acquisitions that are not cost-effective more likely; and
- Raise the costs of some investments because a lease-purchase is, over the life of an asset, inherently more costly to the government than a direct purchase.

The Effects of the 1991 Guidelines

Overall, the new guidelines made the costs of federal activities more visible and contributed to a more disciplined fiscal policy. In 1991, when the guidelines were implemented, the rush toward lease-purchases stopped. In some cases, agencies decided not to undertake investments that—when scored up front with their full budgetary costs—did not appear worth the expense. In other cases, less costly direct purchases replaced lease-purchases. In the early 1990s, for example, DoD abandoned its plan to replace 40 percent of its housing stock using a type of lease-purchase known as Section 801 housing. Instead, it limited its spending on military housing to what could be financed using appropriations.

The guidelines did, however, have an unintended and undesirable effect: some managers turned to other, even less cost-effective approaches. For example, federal managers sometimes chose to rely on a series of operating leases to obtain access to assets for which they had a long-term need—a strategy that is generally less cost-effective than a lease-purchase.³ In some cases, managers designed operating leases for specialized federal assets that, while achieving the effect of a lease-purchase over the long term, were written to avoid triggering the guidelines' requirement for up-front scoring. In other cases, to acquire assets, agencies turned to more-complex financing arrangements, including special-purpose public/private ventures.

The Budgetary Treatment of Public/Private Ventures

In this paper, a special-purpose public/private venture refers to a business entity (such as a corporation, partnership, limited liability company, grantor trust, or other trust) that is created by public and private parties for a single specified purpose and whose activities are predetermined by the contracts and other arrangements between the parties involved. A public/private venture differs from an arm's-length lease or purchase contract in that the government plays a significant role in creating and controlling the venture and the government's claims are subordinate to those of the venture's other creditors.⁴ An example of such a venture would be a limited partnership created by the Army and a private developer for the sole purpose of financing and building housing for military personnel in a particular location.

Supporters of special-purpose public/private ventures argue that such ventures serve a legitimate economic purpose by providing the government with expertise and flexibility available in the private sector. This paper does not examine the validity of that claim; instead, the paper focuses on the budgetary treatment of such ventures. Displaying the nature and full extent of the federal government's financial commitments can help inform decisions about whether the benefits of such arrangements justify the federal costs. The public/private ventures reviewed in this paper—including DoD's housing privatization projects at Fort Hood, Texas, and Elmendorf, Alaska, as well as the Department of Veterans Affairs' (VA's) enhanced-use leasing projects at Mountain Home, Tennessee, and the West Side in

3. An operating lease that led to an outright purchase could, however, still be more cost-effective than a lease-purchase.
4. That control may be exercised through voting rights or positions on governing boards or through contractual agreements that restrict the activities of the public/private venture to serve the government's interests.

Chicago—finance the acquisition of federal assets outside the budget, raising issues about the budgetary treatment that they have received.

Public/private ventures are often complex business arrangements in which explicit lease payments by the government may not be involved or may play a minor role. Instead, the government may contribute to the venture by offering low-cost leases of government property, making commitments to purchase goods or services from the venture, or conveying assets to the venture. Few precedents exist for scoring or recording the budgetary implications of those new arrangements. Although recording commitments up front in the budget is a fundamental principle, the precise level of the federal government's financial commitment and control in such a venture may be unclear.

Agencies often enter into public/private ventures using broad legal authorities, such as those provided to DoD and the VA for, respectively, the privatization of family housing and enhanced-use leasing. At the time the Congress grants such broad authorities, it may be uncertain whether and to what extent agencies will use them to enter into financial commitments. Moreover, under such authorities, agencies need not seek subsequent authorization from the Congress for individual projects. Those factors can limit the role that the Congress plays in determining the budgetary treatment of public/private ventures.

OMB has an opportunity to review individual public/private ventures as the budget is executed, but it may choose not to record obligations and outlays up front if the budgetary precedents are not extremely clear. In some cases, OMB has allowed agencies, including DoD and the VA, to record the obligations associated with contracts with public/private ventures as if each provision in the contracts was an independent transaction between a federal and nonfederal entity. That approach generally keeps ventures' spending on assets, and borrowing to finance that spending, out of the federal budget.

An alternative approach, used by CBO in several of its cost estimates for legislation considered in the 107th Congress, is to consider each public/private venture as a whole to determine whether and to what extent its financial commitments should be reflected in the federal budget. In CBO's view, the factors generally associated with the government's control of an entity—such as cash or in-kind equity investments by the government and, depending on their terms, commitments for purchases, leases of property, and credit assistance—determine whether all or part of many ventures are sufficiently governmental to be included in the federal budget.

The differences between OMB's and CBO's approach to public/private ventures is illustrated by their perspectives on DoD's family housing privatization ventures. In CBO's view, housing privatization ventures that result in the construc-

tion of family housing on military bases should be reflected in the budget as if they were investments by the government because, in effect, it controls the ventures and ultimately will own the housing. OMB takes a different position, emphasizing that DoD may have little if any equity ownership, DoD may not be legally liable for the ventures' debts, and the rental payments are made by individual service members—even though such payments are funded by annual appropriations.

CBO's approach is consistent with the recommendation of the 1967 *Report of the President's Commission on Budget Concepts*, which called for a unified, comprehensive federal budget that encompasses the full range of federal activities. In addition, it is consistent with changes in private-sector accounting practices mandated by the Federal Accounting Standards Board (FASB) in the wake of recent concerns about the lack of transparency and integrity in private firms' financial reports.⁵ Under those new standards, a firm may be deemed to have a controlling financial interest in a special-purpose entity—and be required to include that entity in its own financial statements—even if it does not control the entity through legal ownership or voting rights and even if it is not legally responsible for the entity's debts.⁶ Instead, the firm's controlling financial interest in the entity may arise from contractual rights and obligations such as those that result from loans or debt securities, guarantees, management contracts, service contracts, residual interests in transferred assets, and leases. If a similar concept was used in federal budgeting, it would imply that many of DoD's family housing ventures and the VA's enhanced-use leasing ventures should be included in the federal budget. Their financial commitments and spending would then be recorded as federal obligations and outlays, respectively.

Meeting the Challenges Posed by Leases and Public/Private Ventures

The 1991 guidelines made the budgetary treatment of assets financed through lease-purchases consistent with that for assets purchased directly by the government, thus limiting the ability of agencies to use lease-purchases to avoid recording the costs of investments up front. In response, however, agencies have sought new ways—including the use of public/private ventures—to acquire assets without recording the costs that way.

5. Financial Accounting Standards Board, *Consolidation of Variable Interest Entities*, FASB Interpretation No. 46, No. 240-A (January 2003).

6. FASB uses the technical term variable interest entity in place of the more commonly used but less well-defined term special-purpose entity.

In some cases, those methods have reduced the ability of the budget to facilitate cost-effective decisions and make agencies' commitments visible to the Congress and the public. That situation is exemplified by DoD's plans for public/private ventures to build or rehabilitate more than 120,000 military housing units by 2006. If DoD achieves that goal using its current budgetary treatment of the projects, the department could record approximately \$1.2 billion in federal spending up front while committing to projects that would, if the full costs were recorded up front, require more than \$11 billion in appropriations.

Some analysts argue that the current budgetary guidelines and precedents are adequate to ensure transparency in the budget, provided that they are interpreted broadly and applied consistently. Others argue that changes in the guidelines for leases and new guidelines for public/private ventures are needed to make costs more visible and to facilitate more cost-effective decisionmaking. Still another approach might be to require Congressional authorization of and scoring for individual leases or public/private ventures that involve private-sector financing above a certain threshold.

In addition, some analysts suggest that focusing on how agencies plan, budget for, and manage their real property could improve the transparency of the budget in regard to capital acquisitions. Better long-term planning might reduce the pressure that managers feel to keep the costs of constructing and rehabilitating facilities outside of their budgets. Capital acquisition funds, such as those proposed by the current Administration, might be used to keep capital costs up front in the agencies' overall budget while spreading those costs out over time in program managers' budgets.

All of those approaches merit consideration. However, the purpose of this paper is not to recommend a specific solution but to identify the challenges that financing federal projects through leases and public/private ventures poses for Congressional control over federal spending as well as for the transparency of the budget and its ability to facilitate cost-effective investment decisions.

Chapter One

Introduction to Budget Principles and Their Application to Leases and Public/Private Ventures

Federal agencies sometimes view leases and special-purpose public/private ventures as attractive ways to acquire assets for their use. In the case of a lease, the agency pays for an asset over time through its lease payments. In the case of a special-purpose public/private venture, the agency might pay for an asset over time through its commitment to purchase goods or services at prices that are favorable to the venture or through accepting a below-market rate of return on cash equity or other valuable considerations (including loans, loan guarantees, and leases). Depending on the budgetary treatment of the lease or public/private venture, this approach can allow an agency to acquire an asset without recording the costs of the purchase up front in its budget.

In the 1980s, agencies often used long-term leases to avoid the up-front budgetary costs associated with purchasing assets. In 1991, budgetary guidelines adopted by the House and Senate Budget Committees, the Office of Management and Budget (OMB), and the Congressional Budget Office (CBO) sought to stem the use of such leases by putting them on a level playing field with outright government purchases. However, a recent surge in the use of leases and public/private ventures—including projects undertaken by the Department of Veterans Affairs (VA) and the Department of Defense (DoD)—suggests that the practice of using private financing for federal assets could be coming into wider use once again.

In this paper, a “special-purpose public/private venture” refers to a business entity (such as a corporation, partnership, limited liability company, grantor trust, or other trust) that is created by public and private parties for a single specified purpose and whose activities are predetermined by the contracts and other arrangements between the parties involved. An example of a special-purpose public/private venture would be a limited partnership created by the Army and a private developer for the sole purpose of financing and building housing for military personnel at a particular base. A special-purpose public/private venture differs from an arm’s-length purchase contract or lease in that the government plays a significant

role in creating and controlling the venture, and the government's claims are subordinate to those of the venture's other creditors.

In examining the budgetary treatment of leases and special-purpose public/private ventures, this paper addresses several key questions. Does the budget accurately identify the federal financial commitments entailed by the leases and ventures, providing the Congress and the public with the information needed to monitor asset purchases? Does the budgetary treatment of leases and public/private ventures provide federal managers with an incentive to make cost-effective choices between outright purchases and different types of leases or public/private ventures?

The problem of how to account for leases and special-purpose ventures is not unique to the federal government. Private firms can also use leases and special-purpose entities for various aims, including keeping assets and the associated liabilities from appearing in their financial statements. In the wake of concerns about the transparency and integrity of the financial standards of some major corporations, the Financial Accounting Standards Board (FASB) has provided new guidance to private firms on how to account for borrowing that is undertaken on their behalf by special-purpose entities.

Budget Concepts: Full Funding and a Unified Budget

The federal budget process includes systems for scoring legislation—that is, for tracking the budget authority provided in legislation and for projecting future federal outlays based on that budget authority—and for recording the actual obligations and outlays made by executive branch agencies as they execute the budget.¹ Together, those budget systems provide the federal government with information about spending on different programs, control over the budget totals that shape fiscal policy, and a means to account for the funds spent by federal managers.

The systems reflect two principles that were advanced in the 1967 *Report of the President's Commission on Budget Concepts*. The first is the principle that the full costs of decisions should be reflected in the budget when the government commits to making the expenditures, rather than when cash payments are made. This principle requires agencies to request all funding for a project up front, when the project is initiated.

1. Budget authority is the authority provided by law to incur financial obligations that will result in immediate or future outlays of federal government funds.

Box 1. Capital Budgeting

Proponents of capital budgeting have argued that the federal budget should recognize the costs of capital over time, as the assets depreciate and the benefits are realized. Because those benefits accrue gradually, recognizing costs up front could lead the federal government to underinvest in capital assets.

Nonetheless, the current consensus among U.S. budget experts is that the advantages of recognizing costs up front outweigh the potential disadvantages. For example, the *Report of the President's Commission to Study Capital Budgeting* concluded in 1999 that up-front funding was appropriate because it ensured that policymakers considered the total costs of an initiative before authorizing and appropriating funds for it. Moreover, if the federal government was systematically underinvesting in a broad range of activities, government investment might be expected to have exceptionally high benefit-to-cost ratios. But that is not generally the case.¹

This paper works from the premise that the federal budget should recognize capital costs up front when the decision to invest is made. Thus, treating lease-purchases consistently with direct purchases means that the costs of both should appear up front in the budget. Even under a system of capital budgeting, however, it would be inappropriate to give one budgetary treatment to assets that are financed through leases or public/private ventures and a different treatment to assets that are financed directly by the government.

1. Statement by June E. O'Neill, Director, Congressional Budget Office, on capital budgeting, before the President's Commission to Study Capital Budgeting, April 24, 1998.

The requirement for full, up-front funding serves a number of purposes. By forcing decisionmakers to face the full costs of their decisions when they make them, it may discourage them from undertaking investments that are not cost-effective (see Box 1). By putting the budgetary costs of all decisions up front, it encourages managers to make cost-effective choices between buying an asset outright or making a commitment to pay for it over time. By making the costs of decisions readily apparent in the budget, up-front funding provides the transparency needed for effective Congressional and public oversight. Full, up-front funding also protects Congressional control over federal spending; agencies cannot begin a project with the idea that this action will later force the Congress to appropriate the additional funds necessary for its completion. (The principle of full funding is related to, but broader than, the legal requirements of the Anti-Deficiency Act; see Box 2.)

A second, closely related budgetary principle advanced by the 1967 Commission on Budget Concepts is that the federal budget should be as comprehensive as possible; that is, all activities of the federal government should be shown within a unified budget. The requirement for a comprehensive, unified budget ensures that the budget reflects all federal revenues and spending and thus provides a more

Box 2.
The Anti-Deficiency Act and Full Funding

The Anti-Deficiency Act (31 U.S.C. 1341) prohibits an officer or employee of the United States from entering into contracts or obligations for the payment of money before an appropriation is available, unless authorized by law. It also prohibits the officer or employee from making an obligation in excess of the amount available in an appropriation, unless authorized by law. The Anti-Deficiency Act highlights the point that federal employees and officers cannot spend federal resources without Congressional authority. Under the Anti-Deficiency Act, a federal officer can enter into a contract to purchase the hull of a Navy ship only if the officer has sufficient budget authority to cover that contract.

The principle of full funding is much broader. Full funding would require the officer to obtain all of the budget authority required to complete construction of the entire ship before letting a contract for the hull. Although full funding generally has wide support in the Congress as well as from the Office of Management and Budget, it is enforced through policy rather than by legal statute. Not all agencies and committees of the Congress place the same emphasis on full funding.

accurate picture of the impact of federal activities on the overall economy. Like full, up-front funding, the use of a unified budget contributes to the ability of the Congress and the public to grasp the overall budgetary picture and to monitor agencies' activities. A complete financial picture otherwise is difficult to obtain when an organization distributes its activities among a complex of interrelated, quasi-independent entities.

Over time, the Congress and the other organizations responsible for tracking budget authority, obligations, and outlays—including the House and Senate Budget Committees, OMB, and CBO—have developed guidelines to ensure that the budgetary treatment of federal activities is consistent with those principles. Some of those so-called “scoring guidelines” are set forth in Congressional documents and OMB circulars.² Others reflect an evolving body of accepted practices and precedents. Although sometimes arcane, the guidelines are largely consistent with the principles of up-front funding and a unified budget as they apply to a federal budget that is primarily focused on cash transactions. The up-front scoring of the budget authority and outlays associated with legislation enables the Congress to make decisions while taking account of their full costs, see how legislation fits into the overall plan for federal spending, and determine if any ceilings set in those plans have been breached. Within the executive branch, OMB’s tracking of budget authority, obligations, and outlays during budget execution provides a tool for accountability,

2. The term “scoring” is most appropriately reserved for the process of identifying and tracking the budget authority and outlays associated with legislative initiatives (Congressional scoring). At times, however, it is applied more broadly to include the activities of the executive branch, to record the obligations and outlays incurred during budget execution.

ensuring that managers do not violate the Anti-Deficiency Act by exceeding their legal authority to enter into obligations or make payments.

Applying Budget Principles to Leases and Partnerships

In the case of outright purchases by the government, the extent of the federal financial commitment is clear; it is the purchase price. Consistent with the principle of recognizing costs in the budget up front, budget authority equal to the purchase price is scored when the authority to purchase is provided, and obligations are recorded when the commitment to purchase is made. Outlays are recorded when actual cash payments are made to the seller.

When the government obtains the services or revenues of capital assets through leases or public/private ventures, however, the amount of the federal commitment, and thus the appropriate budgetary treatment, is not always as straightforward. Both leases and public/private ventures can result in assets being created or purchased by the lessor or venture in response to the government's demand. In some of those arrangements, the government will be the primary or sole beneficiary of the services produced over the life of the asset. The lessor or venture may sometimes be no more than an extension of the government—a special-purpose entity that the government creates for the sole purpose of financing the acquisition of an asset. Such leases and ventures have raised a number of questions. When do those arrangements, in effect, create a commitment on the part of the government to purchase an asset that should be reflected up front in the budget? In what cases does the government's involvement indicate that the lessor or the public/private venture should be included in the unified federal budget, rather than viewed as an independent financial entity?

This paper focuses on those leases and special-purpose public/private ventures that provide the government with benefits derived from capital assets that are financed by the lessor or venture. It identifies areas in which the letter of the budgetary guidelines may be being met but the underlying budget principles of up-front funding and a unified budget are nonetheless being violated—a practice that could reduce Congressional control over federal spending as well as the transparency of the budget and its ability to facilitate the cost-effective use of resources.

Chapter Two

The Budgetary Treatment of Leases

The federal government has long relied on leases as one way to obtain the use of buildings, equipment, and other forms of capital. The organizations most concerned with federal budgeting—the Congressional Budget Committees, the Office of Management and Budget, and the Congressional Budget Office—have adopted relatively clear and consistent guidelines for the budgetary treatment of leases. Those guidelines, which were first set forth in connection with the Budget Enforcement Act of 1990 (BEA) and later refined in the conference report to the Balanced Budget Act of 1997, distinguish among different types of leases. Some leases are, in effect, to be viewed as purchases of assets. In accordance with general budget principles, budget authority equal to the present value of lease payments over the life of such a lease—that is, the full costs of the commitment—is scored up front, at the time that budget authority is first provided for the lease, and the corresponding obligation is recorded up front when the lease is signed. Other leases, however, reflect the purchase of the services of an asset for only a part of its life; their budget authority is scored and obligations are recorded on an annual basis rather than capitalized.¹

Rapid growth in the use of lease-purchases in the 1980s highlighted the need for up-front scoring of those leases that amounted to asset purchases. In response to budgetary pressures, federal managers increasingly relied on such leases even though, viewed over the life of the asset, they were almost always more costly than outright purchases. In addition, the extensive use of leases threatened to undermine efforts to control total federal spending. The guidelines for the budgetary treatment of leases that accompanied the Budget Enforcement Act of 1990 were expected to curb the rapid growth of leasing, promote fiscal discipline, and encourage more cost-effective choices between leases and outright purchases.

1. For simplicity, the rest of this discussion of budgetary guidelines will refer to budget authority and outlays. Since budget authority is the authority provided by law to enter into financial obligations, the guidelines for recording obligations by the government follow those for scoring budget authority, except that obligations for a particular contract are recorded when such a contract is signed, rather than when the authority is granted.

Box 3.
The Criteria for Operating Leases

According to the Office of Management and Budget, to qualify as an operating lease with the government, a lease must satisfy six criteria:

- Ownership of the asset remains with the lessor during the term of the lease and is not transferred to the government at or shortly after the end of the lease term;
- The lease does not contain a bargain-price purchase option;
- The lease term does not exceed 75 percent of the estimated economic life of the asset;
- The present value of the minimum lease payments over the life of the lease does not exceed 90 percent of the fair market value of the asset at the beginning of the lease term;
- The asset is a general-purpose asset rather than being for a special purpose of the government and is not built to the unique specification of the government as lessee; and
- There is a private-sector market for the asset.

Source: Office of Management and Budget, *Preparation, Submission, and Execution of the Budget*, Circular No. A-11 (2002), Appendix B.

Although the BEA guidelines for leases were adopted in response to the specific budgetary problems of the 1980s, they might also be viewed as part of a gradual and sometimes erratic long-run shift toward a budget process that provides greater visibility and control over federal spending. Evidence of that shift is seen in the 1967 Commission on Budget Concepts, which set out the basic principles of federal budgeting, and later in the Congressional Budget and Impoundment Control Act of 1974, which gave the Congress the ability to set revenue and spending targets and monitor progress toward those targets. OMB's current guidelines for the full funding of investments—which initially applied only to the Department of Defense's acquisition of weapons systems but now are applied much more widely—are consistent with that trend.

Current Guidelines for the Budgetary Treatment of Leases

Under current budgetary guidelines, leases fall into three distinct categories: operating leases, lease-purchases, and capital leases. Operating leases are limited ones

Table 1.
The Office of Management and Budget's Summary
of Scorekeeping Requirements

| Transaction | Budget Authority | Outlays |
|---|---|--|
| Lease-Purchase Without Substantial Private Risk | Amount equal to asset cost recorded up front; amount equal to imputed interest costs recorded on an annual basis over the lease period | Amount equal to asset cost scored over the construction period in proportion to the distribution of the contractor's costs; amount equal to imputed interest costs recorded on an annual basis over the lease term |
| Lease-Purchase with Substantial Private Risk | Amount equal to asset cost recorded up front; amount equal to imputed interest costs recorded on an annual basis over the lease term | Scored over lease term in an amount equal to the annual lease payments |
| Capital Lease | Amount equal to asset cost recorded up front; amount equal to imputed interest costs recorded on an annual basis over the lease term | Scored over lease term in an amount equal to the annual lease payments |
| Operating Lease | Amount equal to total payments under the full term of the lease or amount sufficient to cover first-year lease payments plus cancellation costs recorded up front | Scored over lease term in an amount equal to the annual lease payments |

Source: Office of Management and Budget, *Preparation, Submission, and Execution of the Budget*, Circular No. A-11 (2002), Appendix B.

that are not considered the equivalent of an asset purchase. As defined in the current scorekeeping guidelines, operating leases satisfy six criteria (see Box 3). Those criteria include a limit on the total amount spent on the lease (90 percent of the asset's fair market value) and a limit on the portion of the useful service life of the asset covered by the lease (75 percent). Because operating leases are not equivalent to an asset purchase, the budget authority for such leases is scored either for the full amount of future lease payments up front or, if the contract includes a cancellation clause, for the first year's payment plus any cancellation penalty, with future years' payments scored incrementally over the term of the lease (see Table 1).

In contrast, the budget authority for a lease that fails to meet the criteria for an operating lease is scored up front for the full present discounted value of all future lease payments, regardless of any cancellation clause.² Scoring the budget authority up front in this way acknowledges that such leases are, in effect, a commitment to purchase an asset on the installment plan. Such leases are either lease-purchases—leases in which the ownership of the asset transfers to the government at the end of the lease—or capital leases, a category that includes all leases that are neither operating leases nor lease-purchases.³

The budgetary treatment of federal outlays for leases also distinguishes between lease-purchases in which the government assumes substantial risk and those in which the private sector retains substantial risk (see Box 4). Lease-purchases with substantial risk for the government are those that most closely resemble the government purchase of an asset. Such a lease will have the same effect on the economy—for example, in terms of crowding out private investment—as would the government's decision to acquire the asset by deficit financing through borrowing by the U.S. Treasury. To reflect that economic effect, outlays for lease-purchases with substantial government risk are recorded over the period that the asset is constructed or acquired. That treatment ensures that such a lease-purchase has the same impact on outlays and deficits as would a debt-financed government purchase. In contrast, outlays for leases in which the private sector retains substantial risk are recorded over the course of the lease as payments are made.

The criteria used to distinguish among the different categories of leases are to some extent arbitrary.⁴ However, the problem of distinguishing among different types of leases is not unique to the federal government. Indeed, the criteria for asset value and service life used in the guidelines to identify operating leases were closely modeled on those used by private firms. For example, to define operating leases in contrast to capital leases, the Financial Accounting Standards Board, which sets the accounting standards used by private industry, applies the limits of 90 percent of an asset's value and 75 percent of the service life consumed by the

2. The present discounted value of the asset cost is scored up front, and an amount equal to the government's imputed interest cost is recorded on an annual basis over the lease period (see OMB Circular A-11 for details).
3. An example of a capital lease is a lease that covers more than 90 percent of an asset's value but does not transfer ownership to the government at the end of the lease. Some analysts argue that all leases that cover the full useful service life of an asset should be categorized as lease-purchases, rather than capital leases. Although ownership does not explicitly transfer to the government, the government fully consumes the asset just as it would in a lease-purchase arrangement.
4. Some analysts argue that guidelines that place leases into discrete categories on the basis of specific quantitative criteria are particularly susceptible to gaming. (See Chapter 4 for a discussion of an approach that does not categorize leases to determine budgetary obligations.)

Box 4.
Identifying the Degree of Risk for the Government

The scoring of outlays for lease-purchases depends on whether substantial risk exists in the lease agreement for the private-sector participants. Applying the scorekeeping guidelines included in the conference report for the Balanced Budget Act of 1997 to determine the degree of private-sector risk involves judgment.¹ Rather than providing an exact definition, the guidelines offer the following illustrative criteria to indicate how a project would be less governmental and would thus entail greater private-sector risk.

- There should be no provision of government financing and no explicit government guarantee of third-party financing.
- Risk of ownership of the asset should remain with the lessor unless the government was at fault for losses.
- The asset should be for a general purpose rather than a special purpose for the government and should not be built to the government's unique specification as the lessee.
- There should be a private-sector market for the asset.
- The project should not be constructed on government land.

1. U.S. House of Representatives, *Balanced Budget Act of 1997*, conference report to accompany H.R. 2015, Report 105-217 (July 30, 1997), pp. 1010-1013.

lease.⁵ Similarly, under FASB's standards, for a capital lease, the lessee records the liability on the basis of the present discounted value of the minimum lease payment over the term of the lease, whereas for an operating lease, the lessee does not capitalize the costs but treats them as expenses over the term of the lease. (In FASB's terminology, both lease-purchases and capital leases would be characterized as different kinds of capital leases.)

Factors Contributing to the Adoption of the Current Guidelines

Before the implementation of the current lease-purchase guidelines in 1991, OMB's standard practice was to record the budget authority and outlays for lease-purchases that were specifically exempted from the Anti-Deficiency Act in their authorizing

5. Financial Accounting Standards Board, "Original Pronouncements, Accounting Standards as of June 1996," *FASB Statements of Standards*, vol. 1 (1996), p. 101.

legislation incrementally, over the term of the lease. That approach made lease-purchases appear much less costly, in the near term, than direct purchases of assets. In some cases, that budgetary treatment encouraged managers to purchase assets that were of lower priority and could not otherwise compete in the budget process. It also encouraged managers to use lease-purchases even if a direct purchase would have been more cost-effective.

The Growth of Leasing in the 1980s

The Economic Recovery Tax Act of 1981 was one factor contributing to growth in the use of leases in the early 1980s in the private, nonprofit, and public sectors. Firms are taxed on their corporate profits net of the depreciation charges on their assets. Under the 1981 tax law, firms were able to reduce their corporate tax liabilities by investing in assets and then taking both an investment tax credit and accelerated depreciation charges. They then leased the assets to government agencies or to other firms that could not take advantage of the favorable tax treatment.

The Deficit Reduction Act of 1984 eventually reduced the tax advantages available to owners of assets leased to the government. By then, however, concerns about the size of the federal deficit were driving the government's increasing reliance on lease-purchases. The Balanced Budget and Emergency Deficit Control Act of 1985, also known as Gramm-Rudman-Hollings, set ceilings for federal deficits and provided for the automatic sequestration (or cancellation) of appropriations if those ceilings were breached. Lease-purchases and capital leases offered a way for agencies to gain access to capital without formally breaching the deficit ceilings. Although the lease-purchases had the same impact on the economy as deficit spending had, their impact on measures of the federal deficit was spread over many years.

Because lease-purchase payments could be spread over an asset's entire useful life, they were especially attractive to agencies seeking costly, long-lived assets, such as ships or buildings. In the early and mid-1980s, the Navy successfully used "build to charter" contracts to acquire 13 prepositioning ships and five T-5 tankers to transport petroleum products. In each case, the Navy agreed to charter vessels that were built to its specifications using private capital. The business arrangement, while typical for a build-to-charter project, was very complex (see Box 5).

In another use of lease-purchases, DoD obtained on-base housing units for military families. The 1984 Military Construction Authorization Act (Public Law 98-115, section 801) gave DoD authority for a program in which contractors would build housing that DoD would lease back for up to 20 years. At the end of the lease, DoD would have the right to acquire the units. The units, many of which were to be on federal land, were built to DoD's specifications and assigned rent-free

Box 5.**The Structure of a Lease-Purchase: the Example of T-5 Tankers**

In the early 1980s, the Navy arranged a build-to-charter program for five T-5 tankers. The winning bidder, Ocean Shipholdings, established separate special-purpose entities (SPEs) to act as the contractor for each vessel. The SPEs obtained construction financing through commercial bank syndicates. SPEs are often used for that purpose because they assure the lender that the project is isolated from any losses the parent company might incur in its other operations.

Once each vessel was completed, the SPE sold it to a lessor trust and then leased it back. The SPE then chartered the ship to the Navy for five years, with three or four five-year renewals and a purchase option at the end of the charter. The SPE paid back its construction loan using proceeds from the sale of the ships to the lessor trust. The lessor trust funded its purchase of the vessels with a combination of equity provided by investor companies (30 percent) and debt (70 percent). The investor companies were the legal owners of the vessels, although the vessels were designed specifically to meet the Navy's needs, with the expectation that they would be used by the Navy throughout their service life. The investor companies received a return from a combination of lease payments, tax benefits in the form of accelerated depreciation, and the residual value of the vessels.

The debt was financed through the Federal Financing Bank (FFB), a wholly owned corporation of the United States that was created to make low-cost loans to federal agencies as well as to nonfederal borrowers whose loans are guaranteed against default by a federal agency guarantee. Although the Navy did not provide a guarantee against default in this case, its charter agreement was considered to be equivalent. The FFB did not provide financing during the construction phase of the project because the construction contract entailed risk for private-sector entities. For subsequent phases of the project, however, the FFB provided low-cost financing (one-eighth of a percentage point above the applicable Treasury rate). Costs would have been greater if private-sector borrowing had been used.

The reliance on 30 percent private equity was advantageous to the Navy—although not to the federal government as a whole—because the tax benefits that the owners received allowed them to accept a low interest rate. That tax advantage has since been eliminated, and a 1997 study prepared for the Navy by a contractor, the Argent Group Ltd., proposed using 100 percent financing from the FFB in any future charters.

to eligible military members. In 1987, DoD produced a five-year plan that relied on units built under section 801 of the law for 40 percent of its new housing. By 1990, DoD had received authorization for 19,500 Section 801 build-to-lease housing units; solicitations for four projects covering 1,150 units had been issued, and 24 projects comprising a total of 8,160 units were in review.

The General Services Administration (GSA) used lease-purchases to obtain office space for federal agencies. In the 1987, 1988, and 1989 appropriation acts, the Congress authorized GSA to contract for the lease-purchase of a number of specific buildings. In 1989, before implementation of the current guidelines for the

budgetary treatment of leases, GSA was planning to seek additional lease-purchase authority, citing a projected need for \$2.5 billion more for the construction of federal office space from 1991 through 1993. Projects included the Thurgood Marshall Federal Judiciary Building near Union Station in Washington, D.C. (authorized by P.L. 100-480), and a National Archives facility in College Park, Maryland (authorized by P.L. 100-440). Both projects, which were exempted from the Anti-Deficiency Act, involved 30-year lease-purchases. In each case, the government's commitment to make lease payments was the deciding factor in the developer's ability to obtain financing.

Although lease-purchase arrangements were particularly common for buildings and ships, the range of assets that could be leased rather than purchased was very wide. According to one estimate, government agencies in 1990 were leasing more than \$4 billion in automated data processing equipment, most of it through capital leases. In 1990, the Department of Energy (DOE) proposed leasing oil for the Strategic Petroleum Reserve; that proposal, however, was not implemented.

Concerns About Fiscal Discipline and the Efficient Use of Resources

By the late 1980s, the proliferation of lease-purchases was a source of concern within the Congressional Budget Committees, OMB, and CBO. In October 1988, the acting director of OMB notified the heads of executive departments and agencies that, although "a number of agencies and committees of Congress have proposed financing schemes involving lease-purchase arrangements," those arrangements understated the cost of capital acquisitions in the budget and were opposed by the Administration.⁶ In 1989, OMB began to record up front the full costs of some lease-purchases. For example, it recorded borrowing authority and outlays for the National Archives lease-purchase project—a project in which the federal government guaranteed the lessor's debt and had full control over the design and operation of the new building—in the same way it would have recorded borrowing authority and outlays for federal construction financed by federal borrowing.⁷

The demand for a budgetary treatment that would consistently put the costs of lease-purchases up front in the budget reflected three basic concerns. One was that the ability of agencies to rely on private borrowing—albeit private borrowing backed by future lease payments by the government—had the potential to seriously undermine fiscal discipline, rendering limits on deficits or caps on federal spending

6. Memorandum from Joseph Wright, Acting Director, Office of Management and Budget, to heads of executive departments and agencies (October 19, 1988).

7. *Budget of the United States Government, Fiscal Year 1991*, p. A-92.

ineffective. In some lease-purchases, financing was obtained using certificates of participation that were backed by the government's promise to make lease payments. In other cases, a special-purpose entity—distinct from the government and the vendor of the asset—was created to borrow the funds needed for the project, pay off the vendor, and then manage the transfer of the government's lease payments to creditors. Regardless of the exact method used, the effects on the economy—including the potential for crowding out private investment—were essentially the same as they would have been had the Treasury issued debt to finance the asset.

A second concern was that the ability of agencies to avoid the up-front costs of their decisions could make it more likely that they would undertake projects of lower priority, leading to an inefficient allocation of resources. That concern would have been valid even if control of the budget deficit had not been an issue. The likelihood that managers would undertake such investments was further increased by the lack of transparency in the federal budget. As long as the full costs of lease-purchases were not reflected in the budget at the beginning of the lease term, the budget would not provide Congressional overseers and others with the information they needed to effectively monitor and control such investments.

A third concern was that, even if the investment project was a priority, agencies had a strong incentive to use lease-purchases when an outright purchase would have entailed lower budgetary and economic resource costs over the long run. That concern was intensified by the recognition among budget analysts of the time that a lease-purchase is almost always more costly than the direct purchase of the same asset.⁸ For example, according to a 1990 internal CBO analysis of the lease-purchases of the Federal Judiciary Building and of the National Archives facility, in each case the approach was about 10 percent more costly, in present discounted terms, than a direct purchase would have been. Factors that tend to raise the budgetary costs of a lease-purchase include the degree of risk borne by the private sector and the difficulty in ensuring adequate competition for those specialized contracts. One factor that tends to raise the economic resource costs of a lease-purchase is the additional complexity of the transactions. (See the appendix for a detailed discussion of the factors that can cause the budgetary and economic resource costs of a pure lease-purchase to differ from the costs of directly purchasing the same asset.)

8. The tax benefits realized by lessors in the early 1980s made some lease-purchases appear less costly to government agencies than outright purchases. Nonetheless, those leases were still more costly to the federal government as a whole because of reduced tax revenues.

The Effects of the 1991 Lease-Purchase Guidelines

With their implementation in 1991, the lease-purchase guidelines accomplished many of their objectives. They halted the rush toward lease-purchases that had been occurring in the late 1980s, in some cases forestalling lower-priority investment projects. In other cases, the level playing field between lease-purchases and direct purchases led managers to substitute direct purchases for the more costly lease-purchases. The guidelines also reduced the number of leasing authorities provided or extended by the Congress. Yet the guidelines have also had unintended consequences. Federal agencies have, at times, responded to the guidelines by adopting approaches—such as short-term leases—that are even less cost-effective than the lease-purchases they replaced.

Reduced Reliance on Lease-Purchases

In 1991, DoD scrapped plans to enter into additional contracts for Section 801 projects—projects that could not compete in the budget process on a level playing field—when it learned from OMB that the total obligations associated with the contracts would be scored in the first year. Instead, it chose to go forward with a limited number of projects using appropriated funds. Likewise, the Congress decided not to extend authority for Section 801 and similar programs for military family housing in the National Defense Authorization Act for Fiscal Years 1992 and 1993 when it became clear that, under the new rules, direct spending equal to the government’s total obligations under the extended authority would be scored (see Box 6).⁹

After 1990, appropriation acts no longer included provisions allowing GSA to enter into lease-purchase contracts for specific federal buildings. And the Navy ceased acquiring ships through build-to-charter programs, although that change can be attributed in large part to the enactment of an earlier statute—itself a reflection of growing concern about lease-purchases—that required Congressional authorization of long-term leases for vessels and aircraft.¹⁰

9. Direct spending is budget authority provided in laws other than appropriation acts. The National Defense Authorization Act for Fiscal Years 1992 and 1993 did provide for a program similar to Section 801, but with provisions designed to avoid the need for up-front scoring. DoD concluded that those provisions, which would have established what were essentially one-year contracts with up to 24 one-year options that could be terminated at any time without cost to the government, rendered the program unworkable.
10. Title 10 of the *United States Code*, section 2401 (enacted in 1983), prohibits the long-term leasing or chartering of a vessel or aircraft unless the lease or charter has been specifically authorized by law. The prohibition, however, did not apply to the prepositioning and tanker charters to which the Navy had already committed.

Box 6.
The Scoring of Direct Spending

The Congressional Budget Office's (CBO's) scoring of bills that would create or extend federal programs depends in part on whether the legislation is deemed to provide sufficient authority for agencies to enter into obligations in advance, or in excess, of appropriations for that purpose. If a bill provides such authority, CBO's scoring will include direct spending in the amount needed to cover the agreements that agencies are expected to enter into.

On the one hand, a bill that directs an agency to enter into obligations and explicitly waives the Anti-Deficiency Act clearly creates direct spending authority. On the other hand, language that grants an agency general authority to enter into obligations only if it subsequently obtains appropriations for that purpose does not provide direct spending authority. (In that case, CBO will score budget authority if and when appropriations for that purpose are provided.) Some bills, however, fall between those two extremes. CBO's practice is to score direct spending if it believes the agency will interpret wording in the bill to allow it to enter into obligations in advance, or in excess, of appropriations for that purpose.

The effect of the new guidelines on lease-purchases was clearly recognized by those agencies and committees that had relied on them to support capital programs. In May 1991, the Chairwoman of the House Armed Service's Subcommittee on Military Installations and Facilities noted that the guidelines associated with the Budget Enforcement Act of 1990 were having a "devastating impact" on DoD's plans to use third-party financing to provide new housing for military families.¹¹ In 1994, as the impact of the new budgetary treatment continued to be felt, the House Committee on Public Works reported a bill (H.R. 2680) that would have restored the budgetary treatment of leases to pre-1991 practices. Although that bill never became law, the concerns expressed by the bill's sponsors suggested that the new guidelines had reduced GSA's ability to rely on private financing to build federal office space.

Although it is not possible to quantify the effect, such examples suggest that the 1991 guidelines have contributed to efficiency and fiscal discipline by discouraging lower-priority investments. Because the costs of federal purchases are now shown up front in the budget, the result is a more transparent budget that better reflects the full costs of government activities and that provides the information needed for effective monitoring. In addition, the guidelines may also have had some indirect benefits. For example, the need to budget for acquisitions up front has helped increase federal managers' interest in new tools—such as five-year capi-

11. Letter from Representative Pat Schroder, Chairwoman, Subcommittee on Military Installations and Facilities, House Committee on Armed Services, to Robert D. Reischauer, Director, Congressional Budget Office, May 29, 1991.

tal spending plans—that place a greater emphasis on planning for those acquisitions.

Nonetheless, the guidelines have had some unintended consequences. They have led federal officials to seek alternatives to both direct government purchases and lease-purchases. In some cases, those alternatives are less cost-effective than the lease purchases they replaced.

Reduced Reliance on the Direct Purchases of Federal Assets

Given the lease-purchase guidelines, federal managers seeking to maintain or increase their agencies' production of services while reducing their purchases of assets could take various approaches. They can substitute a series of short-term operating leases for a lease-purchase or capital lease, contract out capital-intensive tasks, or postpone acquiring new facilities and equipment even if doing so might be inefficient over the longer term. Managers have at times used each of those approaches to reduce their direct purchases of assets, although the extent to which the new lease-purchase guidelines have contributed to that practice is uncertain.

Substituting Operating Leases for Lease-Purchases. Since the implementation of the lease-purchase guidelines, GSA has increased its use of relatively short-term leases for general office space. GSA argues that the rental receipts paid by the tenant agencies into its building fund are not enough to cover the up-front costs of construction or lease-purchases. As a result, it sees no alternative to relying on serial short-term leases to meet long-term federal needs even though it asserts that such leases are less cost-effective than lease-purchases.¹²

There is some evidence that GSA has shifted from using lease-purchases to using short-term leases, rather than purchasing buildings outright. Between 1986 and 1989, before implementation of the lease-purchase guidelines, 10 of 12 buildings that the Congress authorized GSA's Federal Building Fund to obtain through lease-purchases were to provide office space for executive agencies. Today, GSA typically obtains the use of such buildings through short-term leases, and its spending to purchase buildings has been directed toward other types of facilities. Since 1995, more than 80 percent of the spending to purchase buildings has been for spe-

12. According to GSA's analysis of nine proposed projects between 1994 and 1996, operating leases were, in present discounted value terms, an average of 8 percent more costly than lease-purchases would have been. GSA's analysis assumed, however, that each short-term lease would be one of a series of short-term leases. If a short-term lease was an interim measure, to be followed by an outright purchase, the end result might still have been more cost-effective than a lease-purchase. See General Accounting Office, *General Services Administration: Comparison of Space Acquisition Alternatives—Leasing to Lease-Purchase and Leasing to Construction*, GAO/GGD-99-49R (March 1999).

cialized facilities, such as courthouses and border stations, that cannot be obtained using short-term leases.

Calculations that look only at budgetary costs overstate the disadvantage of relying on short-term leases for general office space. When the government purchases a building, it takes on the risk that it will not need the asset in the future and that the costs of renting comparable space might fall, making renting more attractive. Those risks represent ownership costs that the government bears only when it chooses to purchase rather than lease. The potential advantages offered by leases are reflected in the fact that about 11 percent of GSA's owned office space was vacant in 2002, while only 3 percent of its leased space was vacant.

In the case of more-specialized assets, however, the disadvantages of substituting a series of operating leases for a direct purchase or lease-purchase are clear. One example of an arrangement that might be considered an operating lease for a specialized asset involves the provision in the Department of Defense Appropriation Act for Fiscal Year 2002 that authorizes the Air Force to lease up to 100 Boeing 767 aircraft in a general-purpose, commercial configuration for up to 10 years.¹³ One plan that the Air Force considered was to lease commercial 767 aircraft, convert them to a tanker configuration, and then pay to restore them to their commercial configuration before returning them to Boeing at the end of the 10-year lease term.¹⁴ If such a lease was implemented, it might meet the technical criteria for an operating lease—the asset being leased would, in fact, be a commercial asset rather than a specialized military asset—and the obligations could be recorded on an annual basis. Nonetheless, CBO estimates that over the long run, using operating leases to obtain the services of tanker aircraft would prove not only more costly than an outright purchase, but also more costly than a lease-purchase agreement.¹⁵

An example of an operating lease for a somewhat less specialized asset is that for the Patent and Trademark Office building, which was designed largely to government specifications and then leased—under an operating lease—for 20 years at \$1.2 billion dollars. Although OMB's classification of that lease as an operating lease was a source of controversy, the General Accounting Office (GAO) eventually concluded that the value of that total lease payment was less than 90 percent of the asset's value, thus allowing the lease to be categorized as an operating lease. GAO

13. Public Law 107-117, section 8159.

14. If that plan was to be implemented, however, the Air Force would require additional authority and funds to undertake the conversions.

15. Letter from Dan Crippen, Director, Congressional Budget Office, to Senator John McCain, May 7, 2002.

also concluded, however, that the operating lease was not a cost-effective alternative.¹⁶

Contracting Out Capital-Intensive Tasks. The lease-purchase guidelines apply explicitly to the budgetary treatment of leases, and not to purchases of goods or services. In some cases, however, the line between a contract for goods and services and a contract that commits the government to paying for a capital asset is not entirely clear. For example, contracting out has enabled DoD to obtain gas, water, and electric utilities at military installations without the need to finance the replacement of its own aging infrastructure of electrical wiring, gas lines, and water or sewage conduits. Instead, DoD pays for the cost of the new infrastructure on its bases over time through the rates it pays suppliers for utility services.¹⁷

Contracting out for utilities may be a cost-effective solution at many military bases if it provides competition and economies of scale. However, even if contracting out for energy services resulted in higher long-run costs, it might be an attractive option for DoD in the short run given the need to recapitalize aging utility systems.

Even if a contract for capital-intensive services is scored as a capital lease with budget authority required up front, it can reduce the reported outlays for an agency in the near term. For example, in the mid-1990s, the Department of Energy developed a plan to purchase environmental remediation services at its Hanford Site in Washington State.¹⁸ Under that plan, the contractor was to build a large remediation facility that had no purpose other than the processing of waste at that site. Although CBO categorized that project as a lease-purchase with substantial risk for the government, OMB scored it as a capital lease, thus allowing outlays to be spread out over the term of the lease.¹⁹

16. General Accounting Office, *Acquisition of Leased Space for the U.S. Patent and Trademark Office*, GAO-01-578R (June 2001).
17. Depending on the circumstances, it might be argued that such privatization contracts have imbedded in them the lease-purchase of new utility systems for the military bases and that the costs of that lease-purchase should be reflected up front in the budget. For an alternative treatment of a similar issue, see the discussion of H.R. 5605 at the end of Chapter 3.
18. The Department of Energy later terminated this plan when the contractor's initial construction estimate rose from \$6.9 billion to \$15.7 billion.
19. OMB's position was that the agreement was a capital lease because it did not include any provision for transferring ownership of the facility to the government. CBO's position was that it was a lease-purchase with substantial government risk because the asset would be fully consumed by the government—it would have no residual value at the end of the lease period.

Some service contracts are clearly hidden lease-purchases and could be scored as such. In a 1995 analysis of a hypothetical agreement by DoD and the National Aeronautics and Space Administration (NASA) to purchase satellite launch services from a private contractor, CBO concluded that the agreement would be a lease-purchase with substantial government risk.²⁰ In that example, the contractor would have financed the construction of launch facilities on the basis of NASA's prior commitment to purchase launch services. The commitment would not have formally transferred ownership of the launch system to the government. Yet CBO concluded that the substance of the arrangement was a lease-purchase, because only a commitment by NASA that covered almost all of the system's costs would be sufficient to allow the developer to obtain financing.

Other proposals for service contracts can be difficult to characterize. A contract for a multiyear lease of automatic data processing equipment might qualify as a lease-purchase, whereas a contract that called for seat management—in which the contractor is responsible for providing computer equipment, software, and maintenance subject to performance criteria—might not. Similarly, lease-purchase guidelines might not apply if the Air Force, instead of leasing Boeing 767 aircraft, entered into a multiyear contract for tanker services in which the contractor provided the aircraft, crews, and maintenance and bore the risk of failing to meet performance goals. The Navy currently has a short-term contract with a private firm, Omega Air, in which it pays \$6,000 per flying hour for the services of a tanker.²¹

Postponing the Acquisition of New Capital Assets. Agencies faced with the up-front costs of acquiring new capital assets—facilities and equipment—often have the option of continuing to produce goods and services using what they have, even if it is old or obsolete. Although that approach can increase the costs of producing output in the long run, it holds down budgetary costs in the short run. DoD, for example, has traditionally spent less on major repair and renovation of its buildings than does private industry. Property managers within DoD assert that renovation projects are often not a high priority, even though failure to invest in buildings ultimately leads to higher maintenance costs.

At the same time, however, there is no clear evidence that the need to pay for capital up front leads to systematic underinvestment in infrastructure such as highways, bridges, and water projects that the government provides for the direct

20. Congressional Budget Office, *Budgetary Treatment of NASA's Advance Commitments to Purchase Launch Services*, CBO Memorandum (June 1995).

21. The Navy uses the tanker to support exercises off the Atlantic coast and to refuel aircraft en route to the Pacific coast. This example illustrates how the budgetary treatment of a lease for tankers depends on its specific provisions, but it does not address the feasibility of using operating leases for tankers in wartime.

benefit of the public.²² Those assets differ from the support facilities cited earlier in that producing them is seen as a core function of the agency involved. To the extent that the lease-purchase guidelines have led agencies to continue to produce with obsolete capital assets, the activities are likely to be ones without strong political support within the agencies or the Congress.

Increased Reliance on Alternative Budgeting Techniques

In some cases, the lease-purchase guidelines encouraged federal managers to seek other budgeting techniques—such as incremental funding, advance appropriations, and revolving funds—that reduce the requirement to recognize the costs of capital investments at the time that the commitment is made. Nonetheless, the budgetary benefits that those approaches offer to agencies are much less than what the benefits from lease-purchases had been. Unlike lease-purchases—which before 1991 could be used to amortize the costs of assets over their entire service life—the newer techniques are generally capable of spreading capital costs only over the period in which an asset is being constructed.

Incremental funding occurs when the Congress appropriates funds for part of a project even though that part has no value as a stand-alone project. Under incremental funding, the agency must enter into a contract that commits it to purchase only the piece of the project that has been funded. Funding, scoring, and contracting proceed by increments. In the case of advance appropriations, the Congress authorizes and appropriates funds for an entire project, but the appropriations do not become available for obligation until later. The budget authority is then scored in the period that it becomes available for obligation. Although the use of incremental funding is almost invariably opposed by budget experts who support the principle of full funding, advance appropriations are sometimes viewed as an appropriate tool to use in the case of acquisition projects that have a few items with long lead times.²³

Evidence that the lease-purchase guidelines have encouraged the use of advance appropriations or incremental funding is anecdotal. Nonetheless, buildings and support ships—the two types of assets that in the past were most often acquired through lease-purchases—figure prominently in a December 2000 briefing that GAO gave to the Senate Budget Committee on assets that were being procured

22. Statement of June E. O'Neill, Director, Congressional Budget Office, on capital budgeting, before the President's Commission to Study Capital Budgeting, April 24, 1998.

23. OMB considers a project to be fully funded if it is covered through a combination of regular and advance appropriations. GAO, however, notes that advance funding could be considered a form of incremental funding.

using those methods. Among the buildings being procured with advance appropriations were a number of federal prisons. The ship construction being funded incrementally included one LDH-8 amphibious ship and two LPD-17 amphibious ships. In addition, DoD's new Large, Medium-Speed, Roll-on/Roll-off (LMSR) ships are being purchased through the National Sealift Revolving Fund. Because the funds are not being appropriated to the Navy's procurement accounts, the Navy argues that "full funding provisions as normally understood for ship acquisition do not apply."²⁴

Although some agencies and Congressional committees are more accepting of incremental and advance appropriations than others, efforts to expand the use of those tools are often criticized on the grounds that they reduce the visibility of costs. For example, in its report on the fiscal year 2002 appropriation for defense, the House Appropriations Committee said it was "dismayed" at the Navy's continued use of such mechanisms, which "only serve to decrease cost visibility and accountability on these important programs."

24. See Ronald O'Rouke and Stephen Daggett, *Defense Procurement: Full Funding Policy—Background, Issues, and Options for Congress*, Congressional Research Service (May 7, 2002).



Chapter Three

The Budgetary Treatment of Public/Private Ventures

Federal agencies are increasingly using special-purpose public/private ventures as a way to access private capital without triggering the lease-purchase guidelines and without recording obligations up front in their budgets. In many cases, there is disagreement about the appropriate budgetary treatment of those new business arrangements. In particular, this review finds significant differences between how the Congressional Budget Office and the Office of Management and Budget view existing public/private ventures. It also describes an evolution from CBO's initial treatment of the Department of Defense's housing privatization authorities and the Department of Veterans Affairs' enhanced-use leasing authorities to CBO's recent treatment of proposals to extend similar authorities to other agencies. The differences in treatment reflect new evidence about how agencies are likely to use their authorities to enter into public/private ventures, rather than a change in CBO's interpretation of budgetary principles or practices.

Beginning in the 1990s, the Department of Defense and other federal agencies—including the Department of Veterans Affairs, the Tennessee Valley Authority (TVA), and the Department of Energy—began to experiment with the use of special-purpose public/private ventures as a way to obtain access to capital. In some cases, the individual public/private ventures were authorized by the Congress. Often, however, the agencies entered into such ventures under the aegis of broad new legal authorities that allowed them to do so without any additional Congressional action. The two most important of those new authorities are the housing privatization authorities that the Congress first provided to DoD in 1996 and the enhanced-use leasing authority that it first provided to the VA in 1991. In addition, some federal entities—including TVA and the Oak Ridge National Laboratory—began to use their previously existing leasing authorities to encourage ostensibly independent, private entities to borrow and invest on their behalf.

The federal government has used different types of cooperative arrangements between public and private entities to serve a wide range of goals, including the development of dual-use military and civilian technologies and productive

peacetime uses for the industrial capacity that the military maintains to meet its wartime needs.¹ This paper, however, focuses on the budgetary treatment of a subset of cooperative efforts: special-purpose public/private ventures that have allowed federal agencies to obtain the services or revenues produced by a specific capital asset without recording up front the obligations associated with purchasing the asset. The rapid growth in that type of public/private venture in the past decade reflects, in part, an effort to obtain private funding for federal assets without triggering up-front scoring under the lease-purchase guidelines.

Many public/private ventures provide leases to the government that are clearly subject to the lease-purchase guidelines outlined in the previous chapter. Yet the lease-purchase guidelines may not be applicable to all public/private ventures. In some ventures, there is no explicit lease of a capital asset, or the lease may be only one element in a complex business arrangement. Rather than making lease payments, the government's contribution to the business arrangement may take the form of committing to purchase services or agreeing to outlease, sell, or convey assets to the venture.² The government may benefit not from the use of the venture's capital assets but from the revenue those assets produce. Few budgetary precedents exist for these new business arrangements, and disagreements sometimes arise about how standard budgetary principles should be applied.

The task of reaching a consensus on the budgetary treatment of public/private ventures is complicated by the fact that attitudes regarding the value of cooperative public/private arrangements tend to color perspectives on their appropriate budgetary treatment. Some observers believe that cooperative arrangements often provide a creative way for the government to take advantage of underutilized assets, benefit from the flexibility and expertise found in the private sector, and circumvent what they consider to be the excessive restrictions that federal acquisition regulations and civil service laws impose on federal activities. Other observers, however, point out that federal regulations and civil service statutes serve legitimate public objectives. They may also doubt whether joint public/private enterprises have any advantages over fully private enterprises and view with concern what they consider to be the government's intrusion into the private sector.

The debate over the utility of cooperative public/private arrangements is not, however, central to this paper. The appropriate budgetary treatment of such arrangements, like that of lease-purchases, depends on the nature and extent of the federal government's control and financial commitments. By reflecting those fac-

1. For a discussion that focuses on the potential benefits from cooperative efforts between government and industry, see Bruce Held and others, *Seeking Nontraditional Approaches to Collaborating and Partnering with Industry* (Santa Monica, Calif.: RAND, 2002).

2. An outlease refers to a lease in which the government is the lessor rather than the lessee.

tors accurately, the budget can provide information that decisionmakers can use to determine whether the benefits of such arrangements justify their costs.

Examples of Public/Private Ventures

Each public/private venture has unique features, so observers may disagree about what is typical. Nonetheless, a review of some recent public/private ventures provides insight into what the ventures are and how they are being used.

Ventures Initiated Under DoD's Housing Privatization Authorities

Under its housing privatization authorities, DoD can enter into public/private ventures that need not be authorized by the Congress on an individual basis.³ Those authorities, first granted DoD-wide in 1996, allow the department to enter into a wide range of financial agreements—including direct loans, loan guarantees, out-leases of land, rental guarantees, bartering arrangements, direct investments by the government, and transfers of property—with private-sector participants to provide housing for military families.

In those ventures, the private partner typically obtains private, third-party financing to build or renovate family housing units for DoD. The department generally provides to the venture a lease for government land and control over the housing units located there. It may guarantee the venture's debt against base closures, deployments, or downsizing. DoD may also provide direct loans or contribute equity to the venture, in some cases becoming a legal partner with an explicit ownership interest in the venture.

The principal and interest on the funds the venture borrows to construct or renovate units, as well as the costs to maintain and manage completed units, are typically covered by rental payments equal to the service members' housing allowances. Because service members who live in the privatized units receive housing allowances whereas those living in conventional DoD-owned units do not, one effect of such ventures is to raise the amount that DoD spends on housing allowances.

In two of the earliest housing ventures—those conducted by the Navy under experimental authorities granted to it in 1994—the housing units were on private land and were to be sold to individual private owners at the end of the project,

3. 10 U.S.C. 2871-2885.

rather than reverting to the federal government. In addition, under the original terms of those projects, the rents paid by military members for the units could exceed their housing allowances. Although military tenants had preferential access, renting to civilian tenants was a practical option. At one point in 1998, civilian tenants accounted for 20 percent of the occupied units at a Navy site in Texas. In the most recent projects, however, the extent of the government's involvement and control over the ventures has been much greater, often making the projects indistinguishable from standard military housing.

For example, in 2001 the Army entered into a limited partnership (Fort Hood Family Housing, LP) with a private partner, Lend Lease Actus. The partnership will own, operate, and maintain all 5,912 units located at Fort Hood, Texas, for 50 years. (The Army often tries to convey all housing units at a particular installation to a public/private venture.) At the end of the 50-year ground lease, the Army has the option to renew the partnership for another 25 years. If it does not renew, the units and land revert to the Army. According to the Army, military members will see no difference in their housing costs or assignments because of the use of the public/private venture rather than standard DoD housing.

The construction of new units and the rehabilitation of existing units at Fort Hood will have an up-front cost of about \$260 million. To cover that cost, the partnership will take out a \$186 million loan, the Army will invest \$52 million in equity, and Bank One will provide \$20 million in equity. Actus will provide an additional \$6 million in equity for additional development at the end of the fifth year. Actus will earn a preferred return on its equity consistent with industry standards (in the range of 10 percent to 12 percent) as well as a share in any partnership earnings beyond that, up to a predetermined ceiling on its earnings. Actus will also provide management services to the partnership for a fee equal to a fixed percentage of the project's gross revenue.

The military services do not always participate as a legal partner in the ventures. At Elmendorf Air Force Base in Alaska, Aurora Housing—a privately owned limited liability corporation specifically created for the purpose—has entered into contracts with the Air Force to build or rehabilitate 828 housing units by 2003 and then manage the units for 50 years.⁴ The up-front cost of the project will be approximately \$100 million. Of that, \$6.3 million is to be equity provided by Aurora's private backers, \$47.99 million is to be a direct loan to Aurora from the Air Force at below-market rates, and \$48 million is to be a first mortgage provided by the Alaska Housing Commission and guaranteed by the Air Force in the event of

4. The firm responsible for managing the units on Aurora's behalf will receive a management fee consistent with the industry standard (in the range of 4 percent to 6 percent of the project's gross revenues).

base closure, deployments, or downsizing. The Air Force also will provide land and existing housing units.

The contracts between Aurora Housing and the Air Force that establish the Elmendorf housing venture specify that they are not a partnership agreement. Nonetheless, Aurora has obtained a private legal opinion indicating that for tax purposes, the Air Force might be viewed as having entered into a partnership. According to that opinion, the Air Force has contributed equity to the partnership in the form of existing land and units. In addition, the Air Force benefits from the venture's earnings, just as a partner would, because of provisions requiring Aurora to deposit residual earnings into a fund devoted to the Air Force's programs for housing and improved quality of life. Ownership risk to Aurora's private backers is restricted because the \$6.3 million in equity, plus an ensured "bid profit" of \$9.0 million, earns a preferred rate of return consistent with industry standards (in the range of 10 percent to 12 percent a year) until the project is able to pay off the preferred return balance.

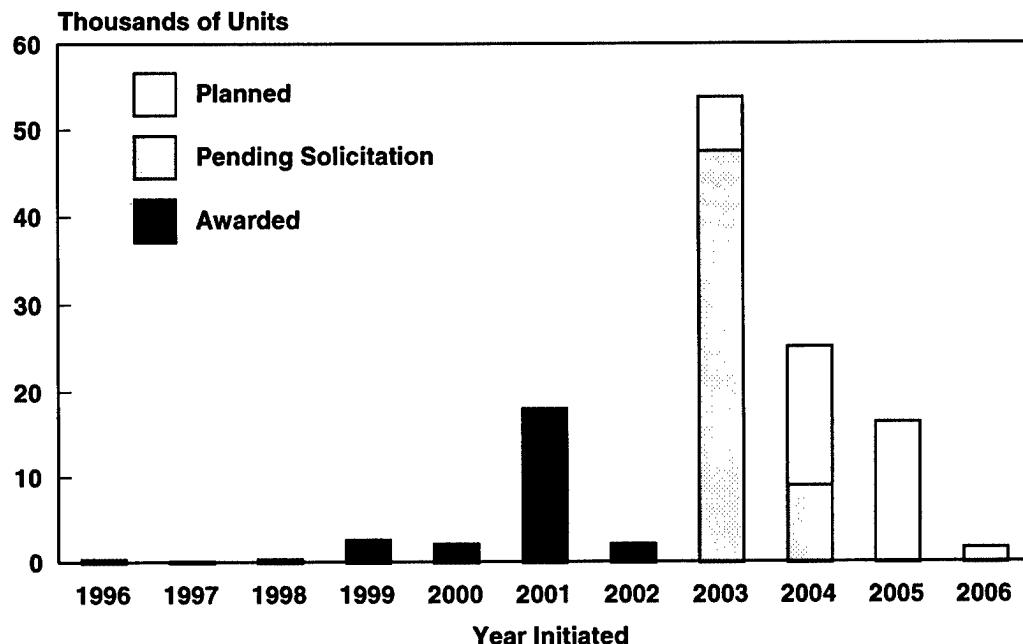
Looking at the Fort Hood and the Elmendorf projects as a whole, one might argue that the military services have a controlling interest in both. Much of that control is exercised through contracts that establish the ventures, ensure that they meet the services' needs, provide for the services to receive a share of any earnings above some threshold, and ensure that the units are in good condition when they revert to the services at the end of the lease. In both projects, the units must be offered first to military personnel, and become available to civilian tenants only if the vacancy rate exceeds some agreed-upon limit. In addition, the ventures cannot charge rents that, together with expected utility charges, exceed the service members' housing allowances.

Since 1996, DoD's use of military housing ventures has increased substantially (see Figures 1 and 2). As of September 2002, DoD had entered into 16 partnerships that will renovate or build 26,166 family housing units at bases throughout the United States. The department was soliciting or preparing to solicit private participants for additional projects covering 56,757 units. Another 40,512 units were covered by projects in the planning stage, bringing the total number of units that DoD plans to have privatized by 2006 to 123,435. By that time, DoD expects that privatized units will constitute more than half of its total stock of leased, owned, or privatized units in the United States.

If DoD carries out its plans, use of the public/private ventures will speed the replacement or renovation of its aging housing units as well as permit the construction of units that the department says it needs to overcome existing shortfalls. DoD estimates that accomplishing that task with appropriations for military construction would take from 30 years to 40 years and cost nearly \$30 billion. DoD's goal is to leverage its appropriation for family housing so that it can obtain \$3 in construction

Figure 1.

Number of Housing Units in the Department of Defense's Military Housing Ventures, as of April 2002



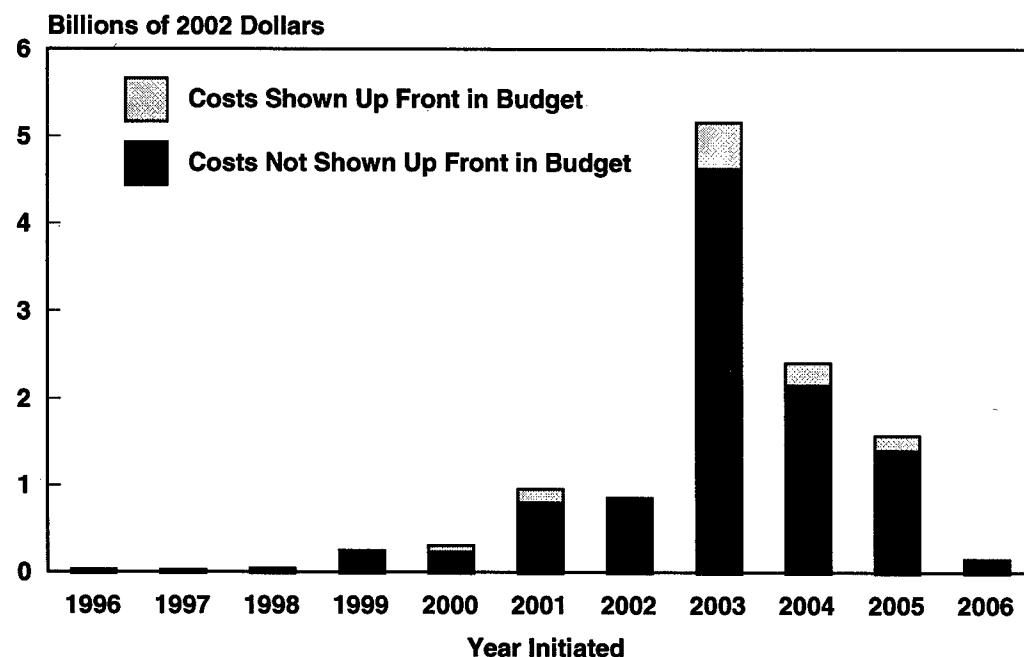
Source: Congressional Budget Office based on data from the Department of Defense.

for each dollar in up-front funding. CBO estimates that as of September 2002, DoD had used the ventures to obtain about \$2.3 billion in housing while recording \$255 million in obligations.

Over the long run, however, it is unclear that housing privatization will reduce DoD's requirements for appropriated funds. The number of service members collecting housing allowances will rise as existing units are privatized and new units are built. The projects may also lead to the construction of on-base units in locations where adequate private housing already exists for military families. DoD's principal justification for the privatization of housing is that the approach will enable the department to meet its goals for the quantity and quality of on-base housing more quickly than it could using military construction.

Ventures Initiated Under the Department of Veterans Affairs' Enhanced-Use Leasing Authorities

The VA first received broad authorities to enter into so-called enhanced-use leases in the fall of 1991. The VA's current authorities allow the agency to lease land to

Figure 2.**The Costs of the Department of Defense's Military Housing Ventures,
as of April 2002**

Source: Congressional Budget Office based on data from the Department of Defense.

private partners for up to 75 years.⁵ The land can then be developed by the private partners for the VA's uses or others'. The VA may use compensation that it receives from the enhanced-use leasing agreement—whether cash, facilities, or services—as it sees fit in pursuing its mission, without any further appropriation. The VA may also lease back for its own use some or all of the facilities developed by the private partners. Although the VA is authorized to enter into contracts under those authorities, it must notify the Congress of its intent 60 days before entering into an enhanced-use leasing agreement.

By 2002, the VA had undertaken enhanced-use leasing to obtain a number of facilities, including office buildings for regional headquarters and parking facilities. In addition, the VA used the approach to obtain services that depend on large capital investments, including the services of electric and steam cogeneration facilities, nursing homes, single-room occupancy facilities, and child care centers for VA employees.

5. 38 U.S.C. 8161-8169.

Mountain Home Cogeneration Facility. The power plant at the VA Medical Center at Mountain Home, Tennessee, provides an example of an enhanced-use leasing venture in which the government is paying for an asset over time through the price it pays for energy. Construction of the plant—a facility that would generate electric power and steam—depended on a series of interdependent agreements signed concurrently on November 1, 1999.⁶ Those agreements do the following:

- Create an owner trust, the Mountain Home Energy Trust, specifically to own and provide financial management for the cogeneration project. The trust's sole asset is the cogeneration plant, and its sole beneficiary is the VA.
- Provide the owner trust with a 34-year enhanced-use lease from the VA for land on which to build the plant adjacent to a large regional VA medical center.
- Establish a development and management contract between the VA, the owner trust, and a private limited liability corporation (Mountain Home Energy Center, LLC) in which the LLC agrees to build the plant for a fixed price and then operate and maintain it for predetermined fees.
- Establish an energy services agreement between the owner trust, the VA, and the LLC setting the terms under which the VA medical center at Mountain Home will purchase utilities from the cogeneration plant.
- Provide for the Johnson City Industrial Development Board to issue \$32 million in taxable municipal revenue bonds.
- Provide for the loan of the bond proceeds to the owner trust to pay for the construction of the cogeneration plant.

The ability of the owner trust to obtain financing to build and operate the plant depended largely on the energy services agreement between the owner trust, the VA, and the LLC. In that agreement, the VA enters into a two-year contract for energy services that would renew automatically over a 24-year period (provided that the VA continues to operate its regional medical center at Mountain Home).⁷ The

6. A description of those transactions is provided in the official statement of the Industrial Development Board of Johnson City, Tennessee, regarding taxable revenue bonds for the project. That statement, identified by the bond issue's CUSIP number (478274CT8), was submitted to the Municipal Securities Rulemaking Board and can be obtained from it.
7. Reported to the Congressional Budget Office in a briefing by the VA, July 26, 2002, and a Memorandum of Understanding, "Enhanced-Use Energy Development at the James H. Quillen VAMC at Mountain Home, TN," entered into between the VA and Energy Systems Group, November 20, 1998.

agreement also sets the prices that the VA will pay for energy. If the VA reduced the quantity of energy that it purchased during the subsequent two-year contracts, its payments for fuel and “standby” electricity would decline, but the portion of its payments that covered capital and maintenance for the plant would remain fixed.⁸ Because of the VA’s purchase commitment, the bonds to finance the cogeneration plant were insured by the MBIA Insurance Corporation and subsequently received a triple-A rating from Standard & Poor’s and Moody’s.

At the end of the 34-year lease, the VA will become the owner of the cogeneration plant, which is to be maintained in good condition by the LLC operating on behalf of the owner trust. During the term of the lease, the owner trust, and ultimately the VA as its beneficiary, will receive a share of the revenues if the facility sells electricity to non-VA customers.⁹

Chicago West Side Regional Headquarters. The VA’s Chicago West Side project provides an example of an arrangement in which the VA uses an enhanced-use lease to obtain a new \$60 million regional headquarters building and parking facility. The financial structure for the West Side project, similar to that used for Mountain Home, also involved a series of interdependent, concurrent agreements.¹⁰ The agreements, dated October 1, 2002, accomplish the following:

- Create an owner trust, the West Side Enhanced-Use Lease Trust, with the VA as the sole named beneficiary.
- Provide the owner trust with a 35-year enhanced-use lease from the VA for a four-acre site adjacent to the VA Medical Center in downtown Chicago.
- Establish the terms under which a commercial development and building management firm (MedPark Development and its affiliate, MedPark Management) will design, build, furnish, and manage the office building and parking facility on behalf of the owner trust and the VA.

8. The contract states that all of the VA’s payments are subject to the availability of appropriations. However, the Johnson City Industrial Development Board, in its official description of the bond issue, interprets the availability of appropriations to mean the availability of appropriations to the VA as a whole.
9. The VA shares revenues (from sales of chilled water and steam) with the state of Tennessee, which has also agreed to purchase services from the cogeneration plant.
10. A description of those agreements is found in the official statement of the Illinois Development Finance Authority regarding taxable revenue bonds for the project. That statement, identified by the bond issue’s CUSIP number (45188RZ77) was submitted to the Municipal Securities Rulemaking Board and can be obtained from it.

- Provide for the Illinois Development Finance Authority to issue \$59 million in taxable revenue bonds.
- Provide for the loan of the bond proceeds to the owner trust to pay for the design and construction of the office building and parking facility.

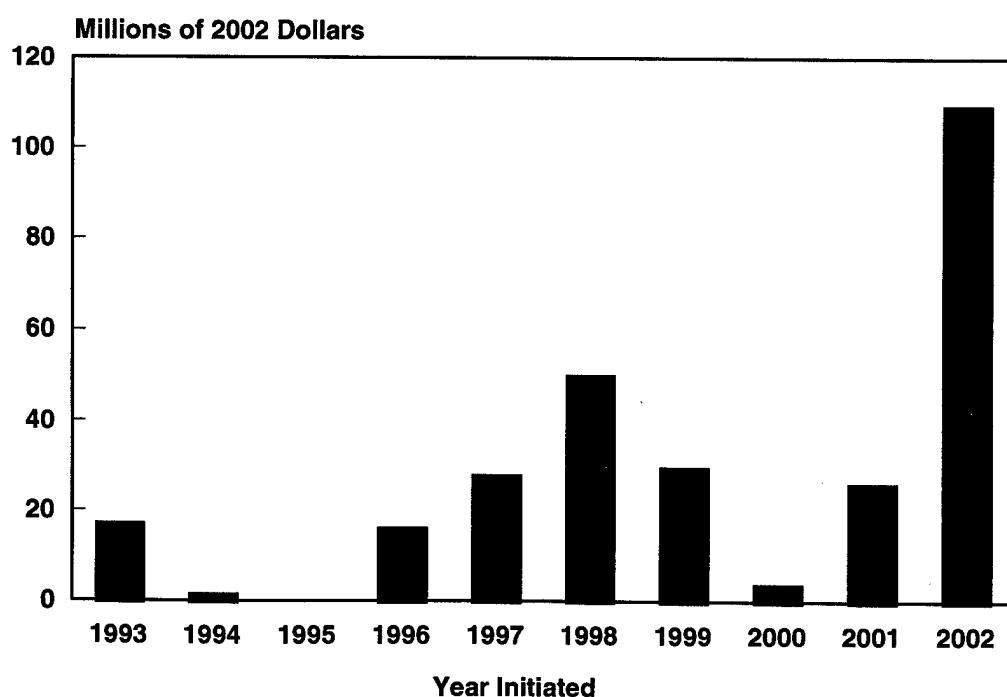
As was the case for Mountain Home, the VA's commitments play a crucial role in allowing the owner trust to borrow through the development authority. Because the VA is committed to a two-year lease of 95 percent of the space in the building and 95 percent of the parking facility, almost all of the owner trust's revenues will initially come from the VA. The initial two-year lease is automatically renewed unless the VA takes specific steps at the end of the lease period to halt it.¹¹ In addition, as long as the VA chooses to occupy any portion of the facility, it must make payments that are sufficient to cover amortization and interest on the owner trust's debt as well as the trustee's expenses. Moreover, the VA agreed that if it vacated the facility, it would not use its enhanced-use leasing authority to secure a replacement. The VA has the right to purchase the building from the owner trust at any time for a price that would cover payments on the trust's debt. In view of the VA's commitments, the bonds to finance the project were insured by Ambac Assurance Corporation and subsequently rated triple-A.

Because the building is in a valuable location at the center of Chicago's medical district, supporters of the project argue that finding another tenant would not be difficult. If the VA vacated all or part of the building and the owner trust leased space to another tenant, the VA would benefit from the lease revenue as the sole beneficiary of the owner trust.

Future Projects. The VA currently plans additional projects and has established an Office of Enterprise Development within its Facilities Management Office to promote the use of partnerships and provide guidelines for their development. It has completed or awarded 24 projects at a total cost of \$283 million (see Figure 3) and is examining the potential of enhanced-use leasing for more than 50 projects in development. Some, although not all, proposed projects involve the acquisition of assets through annual lease payments or purchases of services. The possible number of such projects is substantial, as the VA controls more than 23,000 acres of land and 5,000 buildings at approximately 270 locations. Many of those sites include underutilized buildings or land.

Enhanced-use leasing has both its supporters and its opponents. Many supporters would like to see the authorities extended to other agencies, including

11. The trust is required to offer the VA the opportunity to continue to occupy the building if the agency takes no action at the end of the initial two-year lease, and VA's failure to respond to that offer would constitute acceptance.

Figure 3.**The Costs of the Department of Veterans Affairs' Enhanced-Use Leasing Ventures**

Source: Congressional Budget Office based on data from the Department of Veterans Affairs.

Note: These costs do not appear up front in the federal budget.

GSA and NASA. Supporters note that without the authorities, agencies have little incentive to part with land that may be providing only marginal services. A central feature of enhanced-use leasing is that it provides an opportunity for agencies to exchange underutilized assets for assets or services that they can use fully.

Many opponents are concerned about the effects on Congressional control. They point out that much of the apparent savings from enhanced-use leases arises because projects are not subject to the same restrictions as other government activities. For example, in the case of the VA's Chicago West Side project, much of the savings that the VA expects to receive from relying on enhanced-use leasing (rather than construction using appropriated funds) stems from the assumption that federal procurement regulations and the budget process would slow construction and increase of the cost of the building. Estimated revenues for the enhanced-use leasing project are also greater than they would have been because the owner trust, unlike the VA, can charge non-VA employees for parking.

Another concern is that heavily leveraged public/private ventures—while potentially offering taxpayers a higher expected return—may also subject them to greater market risks. If legislation is needed to allow agencies to benefit from underutilized assets, some analysts argue that a better approach would be to authorize agencies only to conduct outright sales or provide arm's-length ground leases, rather than allowing them—in effect—to use the assets as down payments to secure private financing for projects they might not otherwise pursue.

The debate over the merits of enhanced-use leasing—like the debate over the value of public/private ventures or lease-purchases—is not central to the analysis in this paper. The appropriate budgetary treatment of enhanced-use leases depends on the extent of the federal government's financial commitment and control, not on whether the total benefits of specific ventures justify the financial commitment.

Recent Ventures Initiated by the Tennessee Valley Authority and the Oak Ridge National Laboratory

DoD's and the VA's public/private ventures have been initiated under relatively new legal authorities. Other government activities authorized to operate in a businesslike manner have undertaken similar ventures.

TVA's Lease-Leaseback Ventures. The Tennessee Valley Authority is a federal agency that produces and sells electricity. Unlike most government agencies, it was established with broad authorities to enter into business agreements and to spend revenues without further appropriations. It pays its capital and operating costs from revenues obtained by selling electricity to communities and industries throughout the Southeast and finances much of its investment in land and equipment through sales of bonds to the public. Its borrowing, however, is limited by a statutory debt ceiling of \$30 billion.

TVA has used its authorities in new ways for 16 power plants that it built between 1999 and 2001. In an arrangement called lease-leaseback, TVA leased the power plants for 50 years to special-purpose entities created for that purpose and then leased the plants back for a period of 20 years (or about half of their useful life). The special-purpose entities paid for their 50-year leases with a one-time, up-front payment, while TVA spread its leaseback payments over a 20-year period.

Those transactions generated roughly \$620 million in up-front cash for TVA, allowing it to avoid issuing additional bonds to finance its investments. In effect, the special-purpose entities borrowed on behalf of TVA. They obtained \$527 million through the sale of pass-through certificates. TVA did not explicitly

guarantee those certificates, but the certificates were fully backed by TVA's commitment to make lease payments to the entities for 20 years. Private equity accounted for the remaining \$93 million of the entities' financing.

TVA expected that its approach would allow it to avoid issuing additional bonds that might count against its debt ceiling. Furthermore, the indirect borrowing allowed TVA to benefit from some of the tax advantages that private firms enjoy when they invest in capital assets. The bank that contributed equity to the projects became eligible to deduct the depreciation of the plants from the profits it pays taxes on. Thus, over time, the Treasury receives less tax revenues than it would have otherwise. The contributor of the equity passes some of those tax benefits on to TVA in the form of lower lease payments.¹²

The Oak Ridge National Laboratory. The Oak Ridge National Laboratory, under the control of the Department of Energy, is a government-owned, contractor-operated laboratory complex in Tennessee that conducts scientific research in a wide range of fields, including energy technologies. UT-Batelle, a private limited liability corporation, is the contractor currently operating Oak Ridge under a management and operations contract with the department.

DOE is using its existing authorities to obtain \$70 million in private financing for new office and research facilities at Oak Ridge without recording large up-front obligations and outlays. UT-Batelle, in its role as the operator, has the authority—with DOE's approval—to enter into leases for real property that it needs to carry out its functions at Oak Ridge. DOE, in turn, has the authority to reimburse its operator for those lease expenses as the operator pays them. Those authorities open the door for a new type of lease-purchase or public/private venture.

DOE has provided UT-Batelle Development Corporation, a nonprofit corporation created for this project, with the title to the property on which the new facilities are to be built. The development corporation agreed in turn to lease the site to Keenen Development Associates, the private developer selected to build the new facilities and issue the private bonds that will pay for them. The interest and principal on the bonds, which have been rated A+ by Standard & Poor's, are covered by the commitment of UT-Batelle (the operator) to sublease the facilities from UT-Batelle Development Corporation for an initial term of 10 years followed by three five-year renewals (for a total of 25 years). The sublease payments are designed to cover the costs of building and financing the project. DOE, however, provides the ultimate backing for the bonds, because it has approved the sublease and committed

12. Ultimately, TVA's savings are passed on to TVA customers in the form of lower electricity costs.

to reimbursing UT-Batelle for the sublease payments as a legitimate operating cost of the facility.

DOE is not required to renew UT-Batelle's contract with Oak Ridge when it expires in 2005. The department has agreed, however, to require that any future operator at Oak Ridge assume the sublease of the facilities. At the end of 25 years, DOE has the right to repurchase the land and facilities at a nominal price. It also has the right to ask the operator to cancel the lease agreements earlier, but the department would then lose its right to repurchase the land and facilities. Construction of the new facilities is to be completed by August 2003.

The Budgetary Treatment of Public/Private Ventures

The budgetary treatment of public/private ventures is evolving as Congressional scorekeepers and OMB gain an increased understanding of the types of ventures that agencies are undertaking. For example, CBO recently scored legislation authorizing new public/private ventures for GSA, a DoD laboratory, and the National Aeronautics and Space Administration with direct spending on the grounds that the ventures, which would be effectively under the government's control, would be used to finance government investments. At the same time, however, agencies that already have authority to enter into public/private ventures continue to use them, in essence, to borrow and invest without recording the resulting obligations and outlays up front in the federal budget.

The Roles of the Executive Branch and the Congress

The executive branch is responsible for recording the obligations and outlays for individual public/private ventures during the execution of the budget. Because the actual terms and conditions of a specific public/private venture are not known until a contract is signed, the executive branch bears the frontline responsibility for ensuring that the ventures receive appropriate treatment.

To date, OMB's general approach has been to treat public/private ventures in a piecemeal manner, adding up the explicit financial commitments entailed by each venture without looking at the commitments implied by the venture as a whole. In practice, that approach has meant that investment spending undertaken by public/private ventures on the government's behalf is seldom recorded up front in the budget as a federal commitment.

The task of Congressional scoring is to identify the budget authority and outlays associated with legislation. Because many individual public/private ventures do not require legislation, Congressional scoring plays a limited role in determining the budgetary treatment of individual public/private ventures. Even if an individual venture is the subject of legislation, the legislation may not provide all of the information needed to determine the appropriate budgetary treatment. Nevertheless, Congressional scoring plays an important role in identifying and estimating the extent of federal commitments as the Congress considers renewing, broadening, or providing new legal authorities to federal agencies—and as information on how agencies are using public/private ventures becomes available, Congressional scoring may more accurately identify the budgetary impact of such legislation.

The Budgetary Treatment of DoD's Housing Ventures

When DoD first started using its new housing authorities, it had many questions about how to record its obligations and outlays. In June 1997, OMB and DoD agreed on written guidelines—known as the Raines guidelines—for the budgetary treatment of DoD's housing projects.¹³ Those guidelines identify how obligations and outlays arising from the various provisions found in DoD's housing ventures—including direct loans, loan guarantees, contributions of cash equity, conveyances or outleases of real property—are to be recorded in the budget. The guidelines were to apply to the first 20 privatization projects and then to be revisited to determine their appropriateness. Those OMB guidelines differ from the other budgetary guidelines cited in this paper—including those for the treatment of loans, loan guarantees, and leases—in that they were not agreed to by the House and Senate Budget Committees and CBO and are not used in Congressional scoring.

Taken as a whole, the OMB guidelines allow DoD to use housing ventures to obtain on-base family housing without recording large budgetary obligations up front. To a large extent, that opportunity exists because the guidelines do not consider the possibility that interactions among the different agreements between DoD and a housing venture might create a commitment that is more than the sum of its parts. In most cases, they allow DoD to record each provision in its contracts with a venture as if it was a separate transaction between the government and a purely private entity.

The OMB guidelines for applying credit reform to the loans and loan guarantees that DoD makes to the ventures provide only a partial exception to that treatment. Under the Federal Credit Reform Act of 1990, the budgetary cost of federal

13. Letter from Franklin D. Raines, Director, Office of Management and Budget, to William S. Cohen, Secretary of Defense, June 25, 1997.

Box 7.
Scoring Under Credit Reform

The Federal Credit Reform Act of 1990, enacted as title V of the Congressional Budget Act of 1990, requires the government to account for federal loans and loan guarantees on the basis of the cost of the federal subsidies involved. Before the Federal Credit Reform Act, loans and loan guarantees were accounted for in the budget on the basis of their cash flows. Cash accounting made loans—which involve immediate cash payments, much of which the government can expect to recoup in the future—appear very costly. At the same time, it made loan guarantees—which do not result in any immediate cash payments—appear relatively inexpensive. The costs of loans and loan guarantees could not be meaningfully compared with one another, nor could they be compared with the costs of other programs.

Under credit reform, credit programs appear in the budget in a way that allows their costs to be compared with those of other programs. Credit programs must have budget authority to cover the administrative costs and the net present value of their subsidy costs. For loans, the subsidy costs reflect the present value of the difference between the expected interest on and repayment of loans and other expected net cash flows. For loan guarantees, the subsidy costs reflect the present value of expected defaults and other net cash flows.

A modified approach may be needed in situations in which the federal government provides a loan or loan guarantee and the borrower's ability to repay the loan depends on the government's future purchases of goods or services. If such purchases are very likely, a credit subsidy that is based only on the loan's risk of default will be low. Yet the actual federal commitment can be much larger, because the government may have no choice but to purchase the goods or services in the future or pay the price of the loan default.

loans and guarantees to private entities is not based on their immediate cost but on their net present value over the life of the loans or loan guarantees, taking into account future expected receipts and outlays resulting from the transaction (see Box 7). OMB's Raines guidelines specify that DoD can use credit reform to record its loans and loan guarantees to a housing venture—just as it would use credit reform to record loans or guarantees made to a private entity—only if the venture obtains at least 20 percent of its resources from private sources. Given that the OMB guidelines count private borrowing as a private resource, however, few if any housing ventures would fail to meet the criterion of 20 percent.

In the case of Fort Hood, the Army applied the OMB guidelines by counting its direct investment in the limited partnership as an immediate obligation. Its transfer of land and existing housing units to the limited partnership, which was not a cash transaction, had no budgetary implications. (See Box 8 for a discussion of the standard budgetary treatment of asset sales and barter.) The Army viewed the limited partnership's rentals of units to service members as transactions among private parties. Although the project would increase DoD's future spending on

Box 8.
The Budgetary Treatment of Asset Sales and Barters

Legislation involving sales of government assets is scored on the basis of how those sales affect the flow of cash in the budget rather than on the basis of the economic value of the resources being given up. An asset sale that results in net financial savings to the government is scored on the basis of the estimated change in mandatory spending and collections in each fiscal year. Any change in future discretionary spending that is likely to result (for example, if selling the asset would raise the amount of future appropriations required to lease facilities) is not scored, although it is considered in determining whether the sale results in net financial savings.

The net present value used to determine net financial savings is calculated using the interest rate on Treasury securities with a maturity comparable to that of the service life of the asset plus 2 percentage points. The elements considered in calculating the financial savings include proceeds from the sale; any forgone offsetting receipts that the property would have generated for the government; changes in future spending—both mandatory and discretionary—from the levels that would have occurred if the government had continued to own the asset; and changes in federal revenues, if any, based on special tax treatments specified in the legislation.¹

If legislation involving an asset sale results in net financial costs to the government, proceeds from the sale are not scored, although other estimated changes in receipts and mandatory outlays are scored in the years that they occur, just as they are for a sale that results in financial savings. No budget authority or outlays are scored if, for example, the government sells for \$1 an asset that has a market value of \$200 or that, if had it not been sold, would have reduced the level of discretionary funding required for future rental payments by \$100.

The scoring of barter arrangements also focuses on cash transactions. If a barter results in no change in receipts or mandatory outlays, outlays will not be scored, regardless of the market value of the property. Leases that the government provides in exchange for noncash benefits are treated in a similar manner. Giving away or providing a lease of an asset will result in an amount being scored only if the baseline for the projection period includes offsetting receipts from the sale of the property or from revenues the property would have produced.

If asset sales and barters were not scored in the way they are, an asset might be purchased by the government, with outlays scored, and then given away, with outlays scored again. That treatment would seem to double count the outlays associated with the government's actions. For the purpose of providing information about the cost of resources consumed by the government, it makes sense not to score both the purchase and the transfer of a capital asset. However, the current scoring practice does not provide incentives for cost-effective decisionmaking. The decision to give up an asset imposes an opportunity cost even if it does not affect cash flows in the budget. The opportunity cost is the market value of the asset (under the assumption that such a sale is feasible at a future date) or the asset's value if the government continues to use it, whichever is greater.

1. See Office of Management and Budget, *Preparation, Submission, and Execution of the Budget*, Circular No. A-11 (2001), Appendix A, rule 15.

housing allowances as members shifted to the privatized units and began to collect allowances, that spending was not recorded up front as a budgetary cost of the project.

As a result of that budgetary treatment, Fort Hood will obtain on-base housing units worth an estimated \$273 million¹⁴ while recording up-front obligations of only \$52 million—a leverage ratio of more than five to one. The Army views the limited partnership's debt of approximately \$186 million as the debt of a private entity. The Army, although the major contributor of equity to the limited partnership, is not legally obligated to cover the partnership's debts if the project fails. However, the housing units at Fort Hood are located on federal land, and the terms of the partnership are such that the units are, effectively, under the control of the Army.

Applying the OMB guidelines to the Air Force project at Elmendorf yields a similar result. The land lease and existing housing units were conveyed with no budgetary implications. Furthermore, the Air Force viewed the venture's rentals of units to service members as transactions among private parties, with no budgetary impact. In addition, the Air Force viewed the direct loan of \$47.99 million at below-market rates and the limited loan guarantee of \$48 million as transactions between it and a private entity, estimating that the subsidy cost of that credit assistance was \$23 million.¹⁵ The end result was that the Air Force obtained a \$100 million construction project for an up-front budgetary cost of \$23 million.

The aging of DoD's existing inventories of on-base housing is a serious concern within the department. The ability of public/private ventures to quickly provide adequate, affordable housing has been a powerful factor behind DoD and Congressional support for these ventures. Yet analysts concerned with maintaining Congressional control over federal resources and visibility into federal financial commitments would argue that nonbudgetary financing through public/private ventures is not the best solution. According to those analysts, the Army is using Fort Hood, LP, and the Air Force is using Aurora Housing to acquire assets without recognizing the costs of the purchases in their budgets.

Many analysts who are familiar with budget concepts support viewing DoD's housing ventures such as Ft. Hood and Elmendorf as federal activities and

14. That is an estimate of the cost of obtaining the same project using standard military construction. See General Accounting Office, *Military Housing: Management Improvements Needed as the Pace of Privatization Quickens*, GAO-02-624 (June 2002).

15. That estimate assumes a low risk of default. The low risk of default depends on future appropriations for service members' housing allowances.

including their costs up front in the budget in order to provide a comprehensive view of federal commitments. That perspective, however, has not been reflected in the treatment of those ventures during the execution of the budget. Moreover, the individual projects are not subject to Congressional scoring, and the legislation granting DoD authority to enter into these public/private housing ventures has not to date been scored with direct spending.

Now that more information is available about how these legislative authorities are being used, future legislation extending the current authorities could be scored with direct spending. In 1995, when authority for housing privatization was first granted as part of the National Defense Authorization Act for Fiscal Year 1996, CBO did not estimate any budgetary impact beyond the stated authorizations of appropriations in the bill. CBO observed that some commitments under the authorities could take the form of lease-purchases but assumed that the resulting obligations would be recorded up front during the execution of the budget, so that obligations would not exceed the stated authorizations of appropriations. CBO noted, however, that if the obligations for lease-purchases were not recorded properly during budget execution—that is, if they were not recorded up front—the resulting outlays would exceed those assumed in CBO's cost estimate.¹⁶

When the National Defense Authorization Act for Fiscal Year 2001 extended those authorities from 2001 to 2004, CBO again did not score any direct spending from that action. CBO did, however, note that it believed OMB's accounting for the initiatives was "at odds with governmentwide standards for recording obligations and outlays."¹⁷ In that estimate, CBO reviewed four military housing ventures and concluded that, as projects that achieved the practical effect of government ownership of the properties, they should be recorded in the budget as lease-purchases with substantial risk for the government.¹⁸ As a result, the actual up-front obligations and outlays for the projects were higher than those being recorded by OMB. CBO reiterated its concern when the National Defense Authorization Act for Fiscal Year 2002 extended the housing authorities until 2012.¹⁹ In its cost estimate for the Bob Stump National Defense Authorization Act for Fiscal Year 2003, CBO stated its intent to consult with the House and Senate Budget

16. Congressional Budget Office, *Cost Estimate for the National Defense Authorization Act for Fiscal Year 1996* (July 26, 1995). Outlays would be greater because actual obligations would exceed the budget authority authorized.
17. Congressional Budget Office, *Cost Estimate for the National Defense Authorization Act for Fiscal Year 2001* (May 23, 2000).
18. CBO reviewed ventures at Lackland Air Force Base in Texas, Fort Carson in Colorado, and the Naval Air Stations in Everett, Washington, and Corpus Christi, Texas.
19. Congressional Budget Office, *Cost Estimate for the National Defense Authorization Act for Fiscal Year 2002* (August 22, 2001).

Committees on whether to score future legislation that expands or extends DoD's housing authorities.²⁰

The Budgetary Treatment of the Department of Veterans Affairs' Enhanced-Use Leasing

Like DoD, the VA was initially uncertain about the appropriate budgetary treatment of its public/private ventures. In October 2001, OMB and the VA reached an informal, unwritten decision about how they would record obligations and outlays associated with government leasebacks undertaken as part of enhanced-use leasing projects.²¹ (The term leaseback refers to leases in which the VA is the lessee and the public/private venture is the lessor.) Under that decision, the VA's leasebacks with terms of up to two years would be recorded as operating leases, provided the agency had no right of first refusal on future leases.

That decision, combined with the practice of viewing the initial lease of VA property to the venture as one transaction and any other provisions as entirely separate transactions, could allow the VA to acquire assets without recording the costs up front in the budget. But the Mountain Home and Chicago West Side projects may not illustrate that decision. Although in both projects the VA is acquiring assets using private financing and without recording the full obligation up front, in both cases the VA also appears to be making an explicit commitment that extends beyond two years.

For the Mountain Home project, the VA recorded the lease of land as a barter without budgetary implications. Any revenues that the VA might gain from energy sales to private customers would count as offsetting receipts when they were received, and the agency could spend them without appropriation action. The cost of constructing the facility and the borrowing that financed it were treated as private activities. Up-front obligations were recorded only for the initial two-year contract for energy purchases. No obligations were recorded for the VA's commitment that it would continue to purchase energy from the owner trust at fixed prices as long as

20. An increase in the ceiling on the budget authority that DoD can use to finance the housing ventures might be scored with direct spending, for example, because a stated increase of \$1 billion in the ceiling would, under current recording practices, result in actual obligations and outlays in excess of that amount. See Congressional Budget Office, *Cost Estimate for H.R. 4546, the Bob Stump National Defense Authorization Act for Fiscal Year 2003* (May 3, 2002).

21. Based on July 26, 2002, discussions between CBO staff and Jacob Gallun, Director, Investment and Enterprise Development, Department of Veterans Affairs, and Jim Sullivan, Director of Program Support, Department of Veterans Affairs.

the VA center remained open and that, even if it reduced its level of purchases, it would continue to cover the trust's capital costs.²²

Budget analysts might differ on whether the Mountain Home project is most appropriately viewed as a lease-purchase of a facility plus an operating and management contract; a commitment to purchase services over the life of the enhanced-use lease; or simply (given that the asset and debt are held by a trust naming the VA as the sole beneficiary) the construction of a cogeneration facility directly by the government. If any of those more standard treatments had been adopted, however, the cost of the facility would have appeared up front as a federal obligation.

In the Chicago West Side project, the VA also regards the ground lease it provides to the project as part of a noncash barter transaction with no budgetary implications. Any revenues that the VA might receive back from the owner trust would appear as offsetting receipts when they were obtained, and the agency could spend the funds without appropriation action. The VA views its two-year leaseback of the building as an operating lease and the borrowing by the trust as private borrowing. However, the rationale for viewing the leaseback as an operating lease is unclear. The VA argues that the arrangement is an operating lease because it does not provide the agency with an explicit right of first refusal on future leases. The trust, however, is required to offer the VA the opportunity to continue to occupy the building if the agency takes no action at the end of the initial two-year lease. Moreover, the VA's failure to respond to that offer would constitute acceptance.

The VA's long-term commitment to cover the owner trust's capital costs even if it reduces its occupancy of the building, together with its implicit right to renew the lease, would appear to make the arrangement either a lease-purchase or, if the trust is not viewed as a separate entity from the VA, a government purchase financed by federal borrowing. Because the VA is the only beneficiary of the trust and the trust has a fiduciary responsibility to act in the VA's interests, there is little real distinction between the trust and the VA.

Viewed broadly, the intent of the West Side venture is clearly to provide the VA with capital assets (an office building and a parking lot) that it can either occupy itself or use as a source of revenues without the need to record the cost of the purchase up front. Yet neither the VA's initial written description of West Side submitted to OMB nor the VA's notice of intent submitted to the Congress clearly

22. The Mountain Home project, which predates the October 2001 agreement between the VA and OMB, does not appear to have been treated in accord with that agreement. Given that the VA is required to cover the capital costs of the trust, the agency effectively committed to making purchases throughout the life of the enhanced-use lease. Consequently, many analysts would argue that the obligation should have been recorded up front in the budget. The only dispute might be whether or not that portion of future payments that covered the cost of the facilities should be viewed as part of a lease-purchase and therefore recorded on the basis of its net present value.

describes the trust arrangement or the VA's commitment to cover the cost of capital even if it reduces its use of the building.²³ It is unclear whether OMB or the Congress would have agreed with the VA's budgetary treatment of the project if all of the details had been spelled out. The very complexity of the financial arrangements makes effective oversight difficult.

Because Congressional scoring focuses on legislation, there is no record of how the Mountain Home project or the West Side project would have been scored had they been the subject of very detailed, explicit legislation. In 1999, when the VA's authorities for enhanced-use leasing were renewed, CBO noted that it lacked enough information to estimate their budgetary impact. At that time, CBO believed that enhanced-use leasing arrangements might be expected to result in barter, which would not have any scoring implications.²⁴ Today, however, projects such as Mountain Home and West Side demonstrate that enhanced-use leases can involve more.

The Budgetary Treatment of Ventures Initiated by the Tennessee Valley Authority and the Oak Ridge National Laboratory

Neither the lease-leaseback ventures that TVA used to refinance its power plants nor the reimbursements that DOE is using to finance the construction of new facilities at Oak Ridge required new legislation. Therefore, they did not receive Congressional scoring. Nonetheless, OMB's recent treatment of the TVA's lease-leaseback ventures appears generally consistent with Congressional scoring practices.

Initially, TVA planned to record the money it received from the special-purpose entities up front as cash that would offset expenditures immediately and reduce its need to borrow from the public. It would then have recorded its own leaseback payments to the special-purpose entities as outlays over a 20-year period. After reviewing those transactions, however, OMB noted their similarity to a lease-purchase, or, alternatively, to a government purchase financed by borrowing. According to OMB, TVA has effective ownership of the facilities even though the special-purpose entities are able to claim ownership for tax purposes. The long-term nature of TVA's contracts translates into an obligation that is tantamount to debt.

23. This assessment is based on Department of Veterans Affairs, "Supplemental Information for the Capital Investment Board Application," provided to the Office of Management and Budget, February 20, 2001, and the Enhanced-Use Lease Notice of Intent to Execute, provided to the House and Senate Veterans' Affairs Committees, as required by 38 U.S.C. 8161 et seq.

24. Congressional Budget Office, *Cost Estimate for H.R. 2116, the Veterans' Millennium Health Care Act* (July 29, 1999).

OMB is now requiring TVA to change its recording of those transactions. In 2002, OMB directed TVA to record its most recent lease-leaseback arrangement just as it would have recorded a TVA bond issue—as a means of financing the power plants.²⁵ Under the new treatment, the amounts spent on building the power plants are federal outlays in the years the plants are constructed, and the amounts that TVA receives from its customers for the electricity from those facilities will be recorded as federal receipts over time as the payments are made. Under that approach, the principal benefit that TVA receives from using the special-purpose entities is its share of the tax revenue forgone by the Treasury.

The Evolution of Congressional Scoring

The scoring of H.R. 3947, the Federal Property Asset Management Reform Act of 2002, illustrates how Congressional scoring has evolved in light of recent evidence about agencies' use of public/private ventures.²⁶ That bill—which was not enacted—would have authorized most federal landholding agencies, including GSA, to enter into partnerships and other business arrangements with private firms to improve the government's real and related personal property. Agencies could have sold, leased, or conveyed government property as part of the business arrangements and retained or spent the proceeds without further appropriations. Given the models at DoD and the VA, agencies might be expected to use the authority not only to sell or barter property, but also to enter into public/private ventures that would borrow and spend to finance the construction, renovation, and repair of government buildings.

CBO expected that many of the ventures that agencies would enter into would be used to finance investment on behalf of the government. Because of the extent of the government's control and use of the projects likely to be undertaken, CBO concluded that spending by the ventures associated with that financing should be treated as governmental and recorded as budget authority and outlays. In addition, CBO noted that many of the ventures might involve lease-purchases. On the basis of anticipated spending for projects that agencies had already identified as candidates for such ventures, CBO scored this bill with \$1 billion in direct spending between 2004 and 2012.

In the past year, CBO has used a similar approach in at least two other cases. Once was in scoring a provision, section 241 of the National Defense Authorization Act for Fiscal Year 2003, that allows DoD to establish a limited liability corpora-

25. OMB is also requiring TVA to change its treatment of its earlier lease-leasebacks.

26. Congressional Budget Office, *Cost Estimate for H.R. 3947, the Federal Property Asset Management Reform Act of 2002* (May 16, 2002).

tion at a DoD laboratory. One of the corporation's objectives would be to finance improvements to DoD's research, testing, and evaluation functions. Both DoD and private parties could contribute cash equity, services, or facilities to the corporation. CBO concluded that such a limited liability corporation would be governmental and that its activities—including an estimated \$4 million in borrowing from the public between 2003 and 2006—should be reflected in the federal budget.²⁷

In another case, CBO estimated the budgetary cost of H.R. 5605, which, as reported, would have given NASA the authority to enter into enhanced-use leases and to privatize its utility services under certain conditions. CBO estimated that giving NASA that authority would result in direct spending of \$200 million over five years, with spending possibly exceeding \$1 billion over the next 10 years to 15 years. That estimate reflects the potential projects identified by NASA, NASA's current spending on facilities and utility services, and the way other agencies have used similar authorities to borrow from the private sector and spend the proceeds.

27. See Congressional Budget Office, *Cost Estimate for S. 2514, the National Defense Authorization Act for Fiscal Year 2003* (May 21, 2002).

Challenges for the Budgetary Treatment of Leases and Public/Private Ventures

The 1991 implementation of the lease-purchase guidelines leveled the playing field for lease-purchases and outright purchases, thus closing off one avenue that federal agencies had used to purchase assets without recording the budgetary costs up front. Since then, however, agencies have increasingly gained access to private capital markets without triggering the guidelines. One approach, seen in the lease of the Patent and Trademark Office, has been to write leases that just meet the letter of the guidelines but appear to violate their spirit.

Some agencies have succeeded in using public/private ventures to acquire assets without triggering the requirement to record up front budgetary costs. The government's long-term commitments make it less risky for its private partners to enter into what, from a legal perspective, appear to be short-term arrangements—such as two-year service contracts or leasebacks—but that have the practical effects of a lease-purchase. In some cases, agencies might use special-purpose public/private ventures to access private capital markets without ever entering into a leaseback or purchase agreement. The venture can take a cash or in-kind contribution from the federal government and use it, in effect, as a down payment on a loan to finance an office building or other income-producing investment. The resulting special-purpose entity may exist primarily to serve the government's interests—it borrowed and invested in order to provide a stream of services or revenues for the agency. Yet it holds assets and liabilities that far exceed the agency's original contribution.

A growing number of public/private ventures and leases are being structured to avoid the requirement for recognizing the costs of government investments up front. That trend could reduce the budget's ability to encourage cost-effective investment decisions and to make agencies' commitments visible to the Congress and the public. In some cases, those commitments could challenge Congressional control over federal finances. For example, the Department of Defense's plan to rely on public/private ventures to obtain more than 120,000 family housing units by 2006 could result in the department's recording \$1.2 billion in spending while com-

mitting to projects that would, if the full costs were recorded up front, require more than \$11 billion in appropriations.

Federal budget analysts have proposed a variety of ways to address the challenges. Some methods focus on how lease-purchase guidelines are being interpreted and applied. Others focus on identifying when public/private ventures are effectively under the government's control and are borrowing and investing on behalf of the government. Still other approaches look beyond the budgetary treatment of leases and public/private ventures to the underlying issues of how agencies might more effectively plan, budget for, and manage capital acquisitions within the budget process.

Issues in Applying the Lease-Purchase Guidelines

One concern is that agencies have learned to meet the letter of the lease-purchase guidelines while violating the spirit of the underlying budgetary principles of recognizing federal commitments up front in a comprehensive, unified budget. Some analysts suggest modifying or reinterpreting the guidelines to broaden their application and make circumvention more difficult. Others suggest that less emphasis be put on specific guidelines and that, as a matter of policy, the underlying budget principles should take precedence when the letter of the guidelines is met but their spirit violated.

Broadening the Application of the Lease-Purchase Rule

Two proposals that would broaden the application of the lease-purchase guidelines are often advanced. One, proposed in the past by the General Accounting Office, would extend the guidelines so that operating leases used to meet agencies' long-term needs would be scored up front as if they would be renewed repeatedly over the course of the assets' life. That change would put operating leases used to meet long-term requirements on an equal footing with lease-purchases and construction by the government.

The second proposal, aimed at stopping agencies from using operating leases for specialized government assets that lack a commercial market, is to lower the ceiling on the percentage of an asset's value that can be covered by lease payments over the term of the lease. At 90 percent, the current ceiling may sometimes appear to be satisfied even if a close analysis would indicate that the lease fully covers the cost of the asset. That proposal might be accompanied by a floor on the percentage of the service life covered so that agencies could not reduce total lease

payments below the ceiling of 90 percent of the asset's value by shortening the term of the lease.¹

Both modifications could make disguising an asset purchase as an operating lease more difficult. But they have several disadvantages that may explain why they have not been adopted. They would make the lease-purchase guidelines more complex and difficult to implement. Observers might disagree, for example, about whether an agency had a long-term requirement for an asset. Also, both proposals would widen the gap between the budgetary treatment of leases and the government's actual legal commitments. From a legal perspective, a series of operating leases—even if they meet a long-term need—might be viewed as a series of short-term commitments that only become binding as they are made. Moreover, there is no certainty that broadening the application of the lease-purchase guidelines would always result in more cost-effective decisions. For example, successive short-term leases for a new office building might be more cost-effective than maintaining an existing, aging federal building.

Eliminating the Distinction Between Different Classes of Leases

As long as operating leases and lease-purchases or capital leases are scored differently, agencies will try to obtain leases that fall within the definition of an operating lease—even if to do so is not cost-effective over the long run. Thus, rather than modify the guidelines to narrow the boundaries for operating leases, eliminating the boundary and treating all leases the same might be worthwhile. The Financial Accounting Standards Board—noting that private firms often devise leases that barely fall within the limits for operating leases—has considered requiring firms to capitalize all leases in their books, rather than maintain the current distinction between capital leases and operating leases.² In the context of federal budgeting, capitalizing all leases could mean scoring all leases up front on the basis of the present value of lease payments over the lease term, without attempting to distinguish between leases that are equivalent to purchases and those that are not.

That approach would tighten the linkage between scoring for budget authority and the government's actual legal commitments. It is unclear, however, how

1. A lessor might be willing to risk constructing a specialized asset for the government in exchange for a lease that paid him only 90 percent of its value provided the lease consumed only a small percentage of the asset's service life. He would risk losing the other 10 percent, but the smaller the portion of the service life consumed, the greater his expected return from possible future leases to the government. In practice, the current upper bound of 75 percent of the asset's service life that an operating lease can cover is seldom a constraint.

2. See Warren McGregor, "Accounting for Leases: A New Approach," *Financial Accounting Series*, Financial Accounting Foundation (July 1996).

outlays would be treated if the federal government adopted this approach for budget authority. One solution might be to record outlays over the term of construction for all leases that involve the production of new assets designed for government use and to record them at the time the lease is signed for those that do not. Other options include maintaining the current practice for recording outlays (together with the incentive that agencies now have to write leases that just avoid qualifying as lease-purchases) or recording outlays over the term of the lease (which brings the risk that agencies would choose leases over construction by the government to obtain the slower rate of outlays).

Increasing Reliance on Budget Principles and Reducing Emphasis on Guidelines

Because even the most carefully written guidelines can be exploited, not all analysts support making additional modifications to the existing guidelines for the budgetary treatment of leases. Instead, some analysts favor an approach placing greater emphasis on meeting the spirit of key budgetary principles and less emphasis on satisfying specific quantitative criteria. The approach, which would be similar to the one used in Europe for financial reporting, has been recommended by some private-sector accountants in the United States as an appropriate response to the accounting failures recently experienced at major private corporations. If the approach was applied to federal budgets, those responsible for determining the appropriate budgetary treatment of leases and public/private ventures would have greater discretion to make final decisions on the basis of adhering to underlying principles, even if an agency's proposal meets the letter of specific guidelines. But with greater use of discretion and less reliance on explicit guidelines, scoring could become less consistent and agencies might be less able to understand how their proposals would be treated in the budget.

Issues in the Budgetary Treatment of Public/Private Ventures

In the case of leases, questions about the appropriate budgetary treatment arise when a narrow application of the 1991 guidelines fails to capture the spirit of the underlying budgetary principles. In the case of public/private ventures, however, no strong consensus has yet emerged about what the guidelines for budgetary treatment should be.

The discussion below is limited to the immediate challenges posed by the budgetary treatment of special-purpose public/private ventures used by the govern-

ment to secure private financing for assets that serve its interests. Ideally, guidelines for the budgetary treatment of such ventures might be part of a broader framework rationalizing the treatment of different types of government investments—loans to specific private enterprises, more general investments in private bond or equity markets, and investments in public/private enterprises.³ That unified budgetary theory is, however, beyond the scope of this paper.⁴

Treating Public/Private Ventures as Private Entities

The activities of many public/private ventures are being recorded during the execution of the budget as if the ventures were private entities. Provisions in the various agreements between the government and the ventures are recorded on a piecemeal basis as if each was a separate, individual transaction between the government and a private entity. The federal budget reflects neither the borrowing undertaken by the ventures nor the other cash transactions between the ventures and the private sector. Instead, the government's cash payments to the ventures are recorded as federal outlays, and ventures' payments to the government are recorded as receipts. On the surface, that approach may appear to eliminate the need for any special guidelines for public/private ventures, because the standard budgetary treatment for transactions between the government and private entities, including credit reform procedures and lease-purchase guidelines, can be applied.

However, treating public/private ventures as if they were wholly private entities may not encourage cost-effective decisionmaking, transparency in federal budgeting, and consistency with budget principles. Depending upon the extent of the government's control of ventures, the approach can underestimate the level of federal financial activities and fall short of the goal of a unified federal budget that captures all federal activities.

The approach could also undermine the effectiveness of the existing lease-purchase guidelines. The government's long-lived commitments in public/private ventures may make it less risky for the ventures to offer the government leases for specialized assets that are written to just satisfy the criteria for operating leases even though they depend on long-term lease payments. Such leases could result in the

3. For a broader discussion, see Congressional Budget Office, *Evaluating and Accounting for Federal Investment in Corporate Stocks and Other Private Securities* (January 2003), and *The Budgetary Treatment of Personal Retirement Accounts* (March 2000).
4. For a discussion of the role that a new commission on budget concepts might play in addressing those questions, see Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2004-2013* (January 2003), Appendix A.

inefficient use of resources and entail many difficult decisions regarding the application of the lease-purchase guidelines.

Scoring public/private ventures piecemeal also fails to account for the risk that the government may bear. Even if the government attempts to limit its legal liability for ventures' actions in their agreements with private partners, it might not be able to walk away from ventures' activities undertaken on public land. So if such ventures fail, the government could face significant liability.

Developing New Ad Hoc Guidelines

The Office of Management and Budget and those federal agencies most involved in public/private ventures have developed ad hoc guidelines for recording the budgetary impact of some activities such as loans, loan guarantees, and leases, that are undertaken as part of the ventures. Under those ad hoc guidelines, most public/private ventures are treated as private entities. There are, however, some specific types of transactions between the government and public/private ventures that the OMB guidelines do not treat in the same way. For example, for DoD's housing privatization projects, OMB specifies that loans and guarantees must be recorded at their full value, rather than on a subsidy basis, if the public/private venture does not obtain at least 20 percent of its resources from private sources. Similarly, leasebacks undertaken by the Department of Veterans Affairs as part of enhanced-use leasing ventures could be treated as capital leases or lease-purchases if they exceed two years.

Recently, OMB has considered developing new, more formal guidelines for the budgetary treatment of leasebacks undertaken as part of public/private ventures. Under that proposal, a government agency leasing an asset from a public/private partnership would obligate the present value of the net cash flows to and from the government over the term of the lease.⁵ The approach suffers from a number of serious weaknesses. One is that it would apply the same discount rate to both the government's certain lease payments and the uncertain future receipts the government might obtain from the venture as a result of those lease payments. Another is that it focuses on leases *per se* rather than on the extent of the federal government's commitment. A federal agency could potentially use borrowing by a public/private venture to leverage its commitments, including contributions of cash or in-kind equity, to acquire assets even if the government did not enter into a leaseback or purchase agreement.

5. Under the proposal, the venture's future payments to the government expected to result from the government's leaseback (but not those resulting from the venture's other activities) would be netted against the government's lease payments to the venture.

Including Public/Private Ventures in the Budget

The budgetary treatment of public/private ventures found in CBO's cost estimate for the Federal Property Asset Management Reform Act differs from the treatment that OMB has applied to similar ventures. CBO's cost estimate suggests that factors generally associated with the government's control of entities—such as cash or in-kind equity investments by the government and, depending on their terms, the government's commitments for purchases, outleases of property, and credit assistance—determine whether all or part of many ventures are sufficiently governmental to be included in the federal budget. That approach is consistent both with the recommendation of the 1967 *Report of the President's Commission on Budget Concepts* and recent changes in private-sector accounting practices mandated by Financial Accounting Standards Board in January 2003.⁶

The President's Commission on Budget Concepts concluded that, to work well, "the governmental budget process should encompass the full scope of the programs and transactions that are within the federal sector and not subject to the economic disciplines of the marketplace." Although the commission recommended that the "budget should, as a general rule, be comprehensive of the full range of federal activities," it recognized the difficulty of delineating the boundaries of the federal government. The commission proposed questions to help determine what entities should be included in the budget. The questions go to the issue of whether the federal government controls the entity: "Who owns the agency? Who supplies its capital? Who selects its managers? Do the Congress and the President have control over the agency's program and budget, or are the agency's policies the responsibility of the Congress or the President only in some broad ultimate sense? The answer to no one of these questions is conclusive, and at the margin, where boundary questions arise, decisions have been made on the basis of a net weighing of as many relevant considerations as possible." In general, the commission recommended a comprehensive budget, with very few exclusions.⁷

In the private sector, firms must ask similar questions to determine if they have "a controlling financial interest" in another entity and must therefore consolidate that entity's financial statements with their own. Recent accounting problems at major corporations such as Enron have highlighted how firms have used special-

6. Financial Accounting Standards Board, *Consolidation of Variable Interest Entities*, FASB Interpretation No. 46, No. 240-A (January 2003).
7. The commission specifically considered whether to recommend including in the budget five government-sponsored enterprises that represented government lending or insurance programs, such as the federal home loan banks and the federal land banks. It recommended that one of them, the Federal Deposit Insurance Corporation, be included because it represented an insurance program of the federal government, which had no private equity interest. It recommended that the others be omitted from the budget only if they were completely privately owned.

purpose entities—which can serve a legitimate role in managing risk by isolating the assets and debts associated with particular projects—in an effort to keep debt off of their own books. FASB addressed that problem in its recent interpretation of what constitutes a controlling interest in variable interest entities, or VIEs. (In its interpretation, FASB substituted the technical term variable interest entity for the commonly used but less well-defined term special-purpose entity.)

Under the private-sector accounting practices in effect in 2001, a VIE used for leasing did not have to be consolidated into the statements of the lessee provided that the VIE had an outside equity investment equal to at least 3 percent of its assets. It was the failure of one of Enron's affiliates—an affiliate that had, in effect, borrowed on Enron's behalf—to maintain 3 percent outside equity that initiated the financial restatements leading to Enron's failure. More generally, private-sector accounting standards require enterprises to include in their financial statements the activities of all subsidiaries in which they have a controlling financial interest, which has in the past generally been interpreted as a majority voting interest.

FASB now provides an alternative to voting rights for identifying a controlling financial interest. The alternative focuses on the primary beneficiary whose interests the VIE serves. According to FASB:

The relationship between a VIE and its primary beneficiary results in control by the primary beneficiary of future benefits from the assets of the VIE even though the primary beneficiary may not have the direct ability to make decisions about the uses of the assets. Because the liabilities of the VIE will require sacrificing the assets of the VIE, those liabilities are obligations of the primary beneficiary even though the creditors of the VIE may have not recourse to the general credit of the primary beneficiary.⁸

The primary beneficiary's controlling financial interest in the VIE may arise from contractual rights and obligations, such as those that result from loans or debt securities, guarantees, residual interests in transferred assets, management contracts, service contracts, and leases.

The interpretation requires that activities of a VIE whose nominal owners have not provided financial support meeting specific criteria be consolidated into the financial statements of the VIE's primary beneficiary. It assumes that if the nominal owners of the VIE have not provided sufficient financial support, then another party (the primary beneficiary) must have provided that support.

8. Ibid.

Public/private ventures come in many forms and often consist of a network of agreements that, considered individually, may not indicate sufficient control by the federal government to include the venture in the federal budget. However, when ventures are considered as a whole in light of the factors usually indicating control, it is often clear that the government's role is such that they should be included in whole or in part in the federal budget.

In some cases, the federal government exercises significant control over a venture even though it has no legal ownership interest in it. In the Elmendorf Air Force Base project, for example, the Air Force is not an owner of Aurora Housing, the limited liability corporation contracting to build or rehabilitate and manage housing units on the base. Many budget analysts would argue, however, that the Elmendorf project is at its heart controlled by and operated for the benefit of the government. Aurora Housing is supported by federal credit assistance and constrained by contractual commitments to serve the interests of its primary beneficiary—the Air Force. The Air Force is the primary beneficiary even though it does not have an equity ownership interest. A similar analysis would conclude that many of DoD's family housing initiatives and VA's enhanced-use leasing projects are sufficiently governmental to be included in the federal budget.

The treatment of public/private ventures included in the federal budget is relatively straightforward and eliminates some scoring issues that present difficulties with treating such ventures outside the budget. For example, loans that a venture obtains from private sources would be treated as loans to the federal government and would therefore be recorded as government borrowing. Also, rules governing leases with private parties would generally not be significant since property leased to a venture would be considered as still held by the government.

The Limits of Budgetary Treatments

Agencies facing budget constraints have an incentive to seek ways to move their investment activities outside of the federal budget, where they will not depend on Congressional appropriations. Those responsible for the integrity of the budget—and for ensuring Congressional control over federal spending—will seek to limit the agencies' ability to do so.

Guidelines for the budgetary treatment of leases and public/private ventures are not the only tool available to the Congress. For example, Congressional control might be enhanced if all leasing or public/private projects that involved private-sector financing above a certain threshold, perhaps \$5 million, had to be authorized individually. Authorizations for long-term leases of vessels and aircraft are already required. Extending that requirement to all large projects that rely on private fi-

nancing would ensure that they received more scrutiny and would provide an opportunity for Congressional scoring of the projects. The DoD and VA projects examined in this paper suggest that—in the absence of such a requirement—broad authorities that allow agencies to enter into public/private partnerships are eroding Congressional knowledge of and control over federal spending.

Another approach would be to reduce the incentives that federal managers have to work outside of the federal budget. To some extent, recent growth in the use of leases and public/private ventures to finance investments in real property reflects agencies' perceptions that the standard federal processes for planning, budgeting, and managing real property are not yielding desirable outcomes. VA property managers, for example, argue that—without the ability to access private capital through enhanced-use leasing—many acres of potentially valuable land owned by the VA would remain underutilized. Until federal agencies have more effective tools and incentives for managing real property, strong pressure will continue for public/private ventures that—in violation of budget concepts—allow federal spending on real property outside of the budget.

Changes in federal property management practices might alleviate some of those pressures. For example, the current Administration has proposed capital acquisition funds as a potentially useful tool. The Congress would authorize an agency's acquisition fund to borrow money up front to purchase an asset, such as a building. Users within the agency would then pay for the asset and interest costs over time. That mechanism would smooth out capital costs in the user's budget even though the agency's total budget would reflect the capital costs up front. A broader but similar proposal would require agencies currently holding an asset to pay the Treasury rent to cover both depreciation of the asset and interest costs based on its market value. Although Treasury receipts would offset the rents in the federal budget as a whole, agencies such as the VA would become eager to give up assets unless the services they provided justified their costs. That approach would encourage effective use of resources but—unlike a system of public/private ventures—would not allow agencies to use idle assets to generate and spend resources outside of Congressional control.

Focusing more on the financial commitments entailed by the government's participation in public/private ventures, modifying or more rigorous enforcing of existing budgetary guidelines; and improving incentives to plan, budget for, and manage capital assets could contribute to a more transparent federal budget. Changes in private-sector accounting standards designed to address corporations' use of special-purpose entities for off-book borrowing and spending could also provide guidance for federal budget analysts. The role of this paper, however, is not to recommend a specific solution but to identify the challenges posed by the growing use of leases and public/private ventures to finance federal projects.

Appendix

The Budgetary and Economic Resource Costs of Direct Purchases and Lease-Purchases

This appendix examines the conceptual basis for differences between the cost of an outright purchase and the cost of a pure lease-purchase. A pure lease-purchase is one in which the government takes full responsibility for an asset and its maintenance and is firmly committed to paying for the asset over time and owning it at the end of the lease. (This appendix does not examine the costs of leases in which the government is not committed to owning the asset. Such leases can be a cost-effective approach in situations in which the government is uncertain about its long-term need for an asset or lacks the expertise and flexibility to manage the asset as effectively as a private lessor would.)

As discussed in more detail later, the government finances a pure lease-purchase by issuing a specialized form of debt promising future lease payments. It would be possible to convert payments on such leases into standard, negotiable instruments backed by the full faith and credit of the United States. A central agency could then serve as a clearinghouse for government leases, consolidating and packaging the payments into notes equivalent to those issued by the Treasury. Although never less costly than an outright purchase, a lease-purchase financed in that way might cost only a little more than an outright purchase. Thus, the fundamental disadvantage of pure lease-purchases is not simply that they are intrinsically more costly than outright purchases—although in practice large cost differentials have often arisen—but rather that the only benefit they can provide is the questionable one of not recording up front all of the costs associated with them.

A pure lease-purchase is invariably more costly than a direct purchase for a number of reasons, but how much more costly it is—as well as the specific reasons for the difference—varies, depending on whether budgetary costs or economic resource costs are being focused on. One standard explanation for the lease-purchase's higher cost, regardless of the type of cost being considered, is that the private sector's risky borrowing rate is higher than the Treasury's risk-free rate. That rationale, however, is misleading.

From a budgetary perspective, the cost to the federal government of a pure lease-purchase is invariably greater than the cost of an outright purchase.¹ One reason is that lease-purchases are often negotiated in a sole-source environment in which the lack of competition sometimes allows the lessor to earn excess profits—for example, if the government agency negotiating the deal is willing to share the benefits of reduced taxes with the lessor rather than claiming them all for the government. Also increasing the cost of pure lease-purchases are the higher transaction costs associated with that more-complex method of financing. Higher budgetary costs can arise as well if—despite the government’s commitments—the lessor still bears some residual ownership risk for which he must be compensated.

A further contributor to the higher budgetary costs of lease-purchases is the provision, which is standard in many long-term lease agreements, that the obligation of the United States to make the lease payments in future years is subject to the availability of appropriations for that purpose. Under the scorekeeping practices of the 1980s, that provision allowed the Congress to authorize long-term leases without recording their budgetary costs up front. In addition, it protected the agency signing the lease from violating the letter of the Anti-Deficiency Act (see Box 2 on page 4 for a discussion of that law).

Yet because the provision gave the arguably incorrect impression that the government was not fully committed to making future lease payments, lenders were uncertain and tended to require a rate of return that included a risk premium for what was essentially risk-free agency debt. That premium can raise the budgetary cost of the pure lease-purchase above that of an outright purchase.

However, not all of these differences in budgetary costs reflect differences in resource costs. For example, the lack of competition for a lease-purchase raises its budgetary costs, but to the extent that the government’s loss is the lessor’s gain, it does not necessarily raise the total economic resource costs. Similarly, if the lessor bears some of the ownership risk of the asset, the government bears less—the total ownership risk is unchanged. In contrast, the cost of the transactions needed to set up, execute, and monitor a lease-purchase is both a budgetary and a resource cost.

A pure lease-purchase is invariably less efficient (involves higher economic costs) than a direct purchase. But it is incorrect to attribute, as many do, the inefficiency associated with a lease-purchase to the difference between the government’s

1. Even though the budgetary cost of a pure lease-purchase to the federal government as a whole is greater than the cost of an outright purchase, the cost to the specific federal agency involved may be less—because the agency may share in some of the tax benefits that the lessor receives (the lessor may deduct depreciation in determining tax liability) and that the Treasury loses (the forgone tax revenue).

risk-free borrowing rate and higher borrowing rates in the private sector. In both a pure lease-purchase and an outright purchase, the government obtains an asset in exchange for a stream of future payments. However, in an outright purchase, the promise of future payments takes the form of a negotiable Treasury instrument; in a lease-purchase, it is the promise of future lease payments, which takes the form of a specialized note. The economic costs and benefits associated with the actual investment project—that is, the opportunity costs of the resources used to produce the asset and the uncertain returns that the asset will generate—are the same for both a lease-purchase and an outright purchase.

The additional economic costs associated with a lease-purchase are attributable to the difference between the two kinds of government borrowing and not to the difference between the government's borrowing rate and the rate demanded for financing risky private-sector projects. Factors that will tend to make financing with a specialized note more costly than Treasury financing include any expected costs of litigation over the terms of the lease, the lack of liquidity associated with a specialized debt instrument, and any additional administrative costs that might be expected.² The more similar a lease-purchase contract is to a direct purchase, the greater the justification for the lease-purchase rule—which requires them to be treated similarly in the budget—but the smaller the likely difference in the economic costs will be. Nonetheless, because the transaction costs associated with agency debt will inevitably be greater than those associated with Treasury debt, there is never an economic rationale for a pure lease-purchase.

2. The cost of a default itself, as opposed to the expected cost of the litigation associated with a default, would count as an expected cost to the lender and as an expected gain to the government. It would not be a net resource cost except inasmuch as it might contribute to market risk.



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